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Economic Growth and Institutions: The influence of External Actors

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Abstract

This paper analyzes the relationship among institutions, democracy, and economic growth. Based on a review of the current literature on institutional analysis, in particular that related with New Institutional Economics (NIE), we identify and propose a mean of integrating additional factors that need to be assessed. In our review, we focus on those studies that emphasize property and contractual rights as being the main explicative variables of economic growth. The principal hypothesis of this current of thought is that liberal (democratic) and market institutions are a prerequisite for encouraging investment, efficiency, innovation, employment, and, consequently, economic growth.

The principal argument of this paper is that, while these variables are relevant, the influence of power groups in the international arena is a decisive explanatory factor that the institutional analysis NIE proposes has erroneously put aside. We attempt to incorporate these power relations into institutional analysis using the concept of path dependence. We introduce path dependence in an econometric cross-country and time series analysis as an independent variable to assess, in a very preliminary way, how it might explain the performance of Latin America developing countries in terms of economic growth.

Our results suggest that path dependence variables are as important as the variables traditionally set forth in the literature on NIE. Although our investigation is still in its infancy, in publishing this article we seek to complement NIE's institutional analysis through introducing variables that are more realistic, complex and useful than the rather simplistic relationships between institutions and economic growth that NIE has heretofore proposed.

Resumen

Este artículo analiza la relación entre instituciones, democracia y crecimiento económico, a partir de una revisión de la literatura especializada en el tema, en particular aquella conocida como Nuevo Institucionalismo Económico (NIE). Nos enfocamos principalmente en aquella corriente del NIE que postula a los derechos de propiedad y a los derechos contractuales como variables explicativas del crecimiento económico. La hipótesis principal de esta corriente es que las instituciones liberales (democráticas) y de mercado son un prerrequisito para incentivar las inversiones, la eficiencia, la innovación y, en consecuencia, el crecimiento económico.

El argumento principal de este artículo es que, si bien las variables mencionadas son relevantes, la influencia de grupos de poder en la arena internacional es un factor explicativo decisivo que ha sido relegado en el

análisis institucional que propone el NIE. Este artículo intenta incorporar este tipo de relaciones de poder a través de un concepto conocido como path dependence. Introducido en un análisis econométrico cross-country y time series como una variable independiente, el path dependence es utilizado para observar, en una instancia muy preliminar, cómo éste puede explicar el desempeño de los países de América Latina en términos de crecimiento económico.

Nuestros resultados sugieren que algunas de estas variables son tan importantes como las variables tradicionalmente utilizadas por la literatura del NIE. Aun cuando nuestra investigación se encuentra en un estado preliminar, la contribución principal de este artículo consiste en complementar el análisis institucional del NIE, con el fin de introducir al análisis variables más realistas, complejas y útiles, en lugar de las relaciones tradicionales y simplistas entre instituciones y crecimiento económico que hasta este momento ha propuesto esta literatura.

1. A critical view of the literature on institutions, democracy and economic growth

The 80s and 90s have ushered in a new political era for many countries throughout Latin America. Decadent military regimes have given way to burgeoning democracies, which not only struggle to consolidate themselves, but also to improve the social and economic situation of the people they represent.

Sadly, however, this has not been the case for the majority of Latin American countries. The prevailing point of view maintained by such organizations as the IMF and the World Bank is that the move towards democracy was a prerequisite for development. Nevertheless, a number of analysts began to question the immediate relationship between these variables. While this relationship has been widely discussed in the literature, no clear link has been established between the phenomena. Nonetheless, there is some measure of consensus that a democratically elected government is able to achieve considerable economic growth by encouraging investment, innovation and employment.

One of the most prolific influences on the discussion in this respect has been institutional design as a catalyst for democracy and growth. Generally speaking, an analysis of institutional design has posed the hypothesis that economic growth and development stems from a respect for liberal institutions and the market, as well as the rights of individuals and society as a whole, and an unambiguous legal system.

It appears that institutions are vital in understanding the complex link between democracy and growth: democracies provide an environment where "suitable" design and implementation of institutions can take place. Much of this literature centers on the work of Douglass North, who defines institutions as the "rules of the game" or, in other words, restrictions that shape the way individuals interact and act to reduce uncertainty and provide a structure for political, social and economic exchange (North, 1990a).

Taking this argument at face value we see that the majority of the literature supports the idea that economic growth and development can be achieved by strengthening two types of institutions. There are the so-called "democratic" institutions, which safeguard and control political contest, and the electoral system, which provides for freedom of speech, the balance of power and our right to assemble, and ensures that the outcomes of political processes are respected by all those involved (Olson, 1997). In other words, we are talking about democratic political regimes where electoral, legislative and judicial institutions play an important role in limiting the actions of the dominant political class and avoiding abusive regulations (Clague *et al.*, 1997). It is important to point out that among these institutions are those that protect property against the abuses of different actors, including the government, which are otherwise known as "property rights". Not only do we include here the political institutions we have already mentioned, but also the civil and legal standards that govern our behavior (Shirley, 2003).

What is more, it is crucial that these political institutions be complemented by others that operate from within the economy to encourage the market and provide incentives for exchange by reducing transaction costs and boosting confidence between economic agents (Shirley, 2003). The role these institutions play in economic growth is extremely important due to their ability to reduce production and distribution costs which in turn influence individuals and other economic actors to apply more efficient mechanisms for investment and production (Engerman and Sokoloff, 2003). Not only do these types of institutions provide the necessary mechanisms to ensure that contracts are honored (otherwise known as "contractual rights"), but also the rules and standards for commercial transactions, which foster a set of beliefs and habits that create favorable conditions for safe and honorable transactions in the economic arena.

The general argument then is clear: there is a relationship, and a virtuous and rational one at that, between democratic institutions and those needed to develop efficient and competitive markets. Democratic institutions are, *ex ante*, cooperative arrangements among the political classes that reduce uncertainty by creating efficient and stable exchanges in the political arena. Over time, this structure may either create or alter economic institutions affecting transaction costs and therefore the efficiency of economic exchange (North, 1990a). Consequently, providing for property rights and building trust between the actors by fostering effective incentive schemes, together with an efficient legal and legislative system to defend them, facilitate organization between individuals and companies. At the same time, these institutions produce incentives that encourage the creation of appropriate and productive transactions between economic agents (Engerman and Sokoloff, 2003). In other words, the link between stability in the political arena and economic development depends heavily on the existence of efficient political institutions. Thus we see that the role of democratic government is crucial for improving growth since it is the only mechanism which ensures autonomous legal processes and avoids predatory practices that are detrimental to high levels of saving and production. This combination encourages investment, long term contracts and capital development (Aron, 2000).

This simple equation has given rise to a number of straightforward arguments —some of which are even prescriptive in nature— about the way a country transitioning towards democracy is able to put its faith in the idea that market policies in developing market institutions are the correct combination of elements for future economic growth. As an example we might cite Clague *et al.* (1997), who consider that a political regime which respects the rule of law is also inclined to respect them in the economic arena as well. They go on to say that the reason for this is that autonomous legislative and legal institutions are better able to protect the property rights of private individuals and avoid abusive regulation by powerful governments. Furthermore, Olson (1997) considers that the rule of law and respect for individual rights form the basis for the protection of contract and property rights. In essence, this has led him to propose simply that the best kind of government is one that ensures contract and property rights, and avoids intervening or developing laws that favor specialized interests or the cartelization of small organized groups.

The remedy for developing countries then seems obvious if we simply go by the literature. However, implementing and maintaining the type of institutions it recommends is a much more complicated task. Even North (1990b: 191) warns that "economically efficient institutions are the exception, not the rule".

As a result, greater care should be taken when delving into this literature. A significant part of the debate on economic growth and democracy in developing countries has revolved around the following questions: *1)* why have not developing countries been able to build and consolidate democratic governments and systems which respect individual and collective rights in order to produce institutions that are able to work efficiently through market economies? In other terms, what are the variables that explain their current economic performance? and *2)* how should developing countries build up these political institutions so as to better protect their market economies and allow for sustained growth? In other words, which institutional design would work best for developing countries?

This paper takes a brief look at the literature in order to critically analyze these questions and the answers it provides. We argue against the *"institution-centric"* model. While institutions are important, they are not the sole most significant part of the socioeconomic process. In particular, our critique centers on a branch of the literature otherwise known as New Institutional Economics (NIE); more specifically on those studies that enhance the property rights variable. Today, the NIE is one of the most influential approaches to this debate, particularly when analyzing the relationships between democratic governments, the market and economic growth. The preferred method of analysis employed in the literature has been econometric cross-section regressions which seek to explain how institutional variables affect economic growth and development. Even so, and despite the wide variety of variables used, the basic idea has been to prove that the better a country designs and implements democratic and market oriented institutions, the better the level of development and growth it can attain. Our review has given us the impression that, however likely, the argument may be circular in nature and the methodologies employed still lack the level of sophistication necessary in order to introduce variables which strengthen this institutional approach (or develop new sources of variables). Perhaps the seemingly circular nature of the NIE approach lies in the fact that it is still unclear whether the "right" institutions create democratic and market oriented systems or the other way round. Historical, cultural and even religious variables may provide better explanations or at least complement those related to causality and order. Nevertheless, it is clear that these variables are very hard to measure and therein lays the second problem: the measurements and proxies that are currently used to analyze institutions are very weak, making assumptions of "institutional strength" from variables that are relatively limited and subjective in nature.

Institutional analysis then seems to be a promising approach. However, it would be wise to consider introducing other variables, as well as consolidating the data bases used to measure institutions if we want to confirm that they actually do play a critical role in the causality relationship between democracy and growth. In short, although the impacts of institutions have been measured, the variables employed and the data collected are still weak, making the conclusions and recommendations drawn from them inconclusive. Moreover, we venture that a crucial variable has been left out of the equation by the majority of institutional analyses: power and the related "path dependence" link. It would be naïve to consider in any conversation concerning democracy and economic growth in developing countries that the institutions they have built have not been affected or sustained in any way by the complex and powerful relationships between political and economic groups inside the country and the influential political capabilities of economic and political interests from abroad. Path dependence then is not only the resistance of powerful internal groups to changes to the institutional setting, but also a phenomenological variable that actually tries to capture the complex process of power. The relationship of power and technology (Foucault, 2004) is a complex process of domination and construction of relationships between different actors. In respect to the literature on institutions, democracy and growth, we propose that the power of international actors (both economic and political) is critical in understanding the real effect of path dependence. Institutions are not built up in a vacuum; and they are not necessarily the product of illuminated and rational minds. What is more, they are not medicines that can be easily prescribed for ailing economies nor would it be possible to hold the nose of a patient reluctant to take it (which is sometimes the impression left by the prevailing literature). This metaphor then is limited: while there is a correlation between institutions and economic growth, the relationship is not linear. In fact, North (2005) himself states that the creation of institutions is a complex historical process where the interests of diverse actors create patterns which they become dependant upon and are capable of defending to result in stability over time. Thus institutions are embedded in the political reality of a society rather than "designed" and implemented rationally. In the case of developing countries, this endogenous pattern of institution building can also be exogenous: historically speaking, foreign interest groups and organizations have been instrumental, not to mention vital, in creating the institutional landscapes they currently enjoy.

Consequently, we consider that the power variable has been largely neglected in this debate. Moreover, it is essential that we introduce this variable in any analysis of the impacts of international actors on the transformation of institutions in developing countries if we wish to advance the agenda of institutional reform. Altering "pre-modern" or "inappropriate" institutions in developing countries (if we assume at this time that these categories are uncontroversial) is not only a matter of pressuring interest groups within the country, but also affecting the interests of powerful economic and political groups abroad.

This paper concludes with a first attempt at introducing the power variable in the analysis of the relationship between democracy, institutions and economic growth. We are developing a data base that will enable us to introduce the importance of power and path dependence in the explanation of institutional design and growth in Latin American countries (taking into consideration both international actors and the pattern of dependence they build up within a country). We present an econometric regression model and the preliminary results we have received. While this is just a first attempt, we think the initial results are encouraging. We are convinced that the introduction of these variables, which are often complex and hard to measure, will enrich the debate and make any recommendations regarding institutional development in developing countries more realistic and fair.

2. Why are developing countries unable to consolidate democratic governments that also ensure efficient economies?

The NIE usually begins with a definition by North (1990) who says that institutions are restrictions built by society to regulate individual action. This infers that institutions focus on the decision making and actions of individuals. However, NIE is clear on the limitations of rational models for individual action, adding beliefs and standards as part of the historical process of institution building (Clague, 1997). This may explain the broad spectrum of variables considered in the study of the evolution of institutions in particular settings over the last few years. We have been able to find a large volume of literature with respect to this phenomenon which ranges from orthodox studies on the search for incentives for bringing about "rational" behavior to others that also incorporate colonial values, geographical accidents, legal customs, and cultural traditions in an effort to explain the existence of certain institutions in some countries.

We begin with the work of North (1990a), who postulates that institutional design (or settings) in a given country may explain the motivation behind individuals and the way they decipher their surroundings. In other words, the collective effect of individual action relies on the specific incentives that institutions give them. Institutions reduce the "price" an individual "pays" for their beliefs and convictions, which is a determining factor in decision making and the ability to calculate their effects or consequences. This is how institutions set the bases for coordination and cooperation, affecting the performance of the society and economy.

Similarly, the existence of institutions that do not support economic growth is explained by poorly designed incentives that fail to motivate individuals and make certain behaviors too costly. North (1990b: 110) explains that Third World countries are poor because their institutions impose a set of costs that make political and economic activity expensive thereby encouraging inefficient production. These informal and formal rules build up a range of restrictions that define the characteristics and performance of organizations through certain incentives that induce specific behavior. "Inadequate" incentives and weak structures that fail to protect property rights are clear disincentives for productive activities and efficient markets (Aron, 2000). Transforming established institutions is costly and makes it difficult for developing countries break down existing incentives which make them poor performers (Clague *et al*., 1997).

Therefore, the problem we must understand is how to change these institutions. Our assumptions on the matter are clear: the task that remains however is to create and encourage institutions in developing countries whose settings are opposed to this "rational logic" oriented towards democracy and economic growth. We need to understand how we can get these countries to migrate from one institutional setting to another. With this in mind, Shirley (2003) divides the variables found in the literature over the last few years into: colonial heritage; conflict and political competence; and standards and beliefs. Other authors, however, have proposed that geographic and commercial factors be added as well.

The most traditional and popular explanation with respect to colonial heritage and its influence on economic growth is based on the colonialist country's origins and the different beliefs, habits, religions and institutions it fosters on its colonies. Countries formerly colonized by Great Britain, for example, have a very different colonial heritage to those colonized by Spain. While interesting, this argument remains imperfect. If we compare countries like Jamaica and the United States, which were both dominated by England during the colonial period, we see that cultural heritage is insufficient to explain the differences in economic performance and growth.

Currently, other authors are trying to construct a more complex variable based on the colonial heritage argument. Acemoglu, Johnson and Robinson (2000) have gone a step further in basing their assertions on three premises. Firstly, certain policies and strategies for colonization resulted in a different set of institutions and independent countries: exploitive states (such as the colonies in Latin America and Africa, for example) and neo-European states (like Australia, New Zealand, Canada and the US). Creating a legacy of solid institutions was not a priority in exploitive colonies. The second premise is that the strategy used in colonization was determined by the potential for increasing the colonialist presence. If colonialists found it difficult to settle then the logic of profitability lead largely to exploitive activities. Acemoglu *et al*. (2000) used the expected mortality rate of initial colonists to support this idea. The third premise encompasses how colonial institutions tended to endure and persist even after a country gains its independence. This may have been difficult to attain under certain especially when instigating fair and equal property rights might prove very costly for the new national elites. Some elites may even resort to maintaining an exploitive mindset for production, rather than choosing to foster endogenous capacity for economic growth. Another factor is the size of the new elite class, which zealously protects its privileges and standing: the smaller the local elite, the larger the proportion of riches each member receives, which is yet motive for maintaining an exploitive production mindset. Lastly, Acemoglu *et al.* (2000) defended the persistence of colonial institutions by explaining that some agents made unrecoverable investments —often complementary to exploitive activities— that invariably supported their continued existence.

The second paper written by Acemoglu *et al*. (2001) goes one step further in an attempt to understand the phenomenon otherwise known as "reversal of fortune" in an effort to explain the current situation of countries like Peru, which were considered rich during colonial times. The rationale behind this is to compare the economic performance of formerly rich countries with those that were relatively poor during colonial times (like Canada), which now enjoy developed economies. The explanation lies in what the authors call "institutional reversal", which describes a type of European colonization that developed better institutions in poor, sparsely populated areas to provide incentives for investment (such as Australia for example). Where the colonist's mindset leaned towards exploitive activities, building up institutions was not given priority. However, these weakened institutions survived to postcolonial times ensuring that power was concentrated in the hands of certain elite groups who created economically inefficient social structures. The fact that these poor institutions were consolidated in the 19th century just as the industrial revolution was taking hold exacerbated conditions for the structural underdevelopment of these countries.

Engerman and Sokoloff (2005) also focus their attention on colonialism as a factor that explains the type of institutions that developed in the new colonies. However, they distance themselves from Acemoglu *et al*. (2000 and 2001) by proposing that the endowments each colony boasted were the main explicative variable. Thus they consider the disparities each colony already possessed (scarcities, crops, climate, or type and density of the local population) created enormous inequalities both within and between them. These factors were critical in allowing systemic differences to arise in the quality and capacity of these institutions in developing countries. In particular three mechanisms were put forward to explain how this inequality could affect the development of institutions in these societies: *a)* political inequality, which allowed a small group within the population to design and implement policies that benefited them specifically and limited the access others had to private property; *b)* military inequality, which affected the monopoly on violence; and *c)* economic inequality, which permitted monopolies or created disadvantageous conditions for other actors in the economic arena.

La Porta *et al.* (1998) and Beck and Levine (2003) have also stressed colonialism as a defining factor in institutional development. However, they chose to analyze this by looking at inherited legal systems. La Porta *et al.* (1998) analyzes the quality of government, defining "good government" as that which provides incentives for moving toward a capitalist economy. The main variable that explains this is the legal system and the extent to which it protects the property and transactions of both private individuals and companies. English common law for example was exported to the British colonies and is considered an attempt to avoid irrational and abusive regulation such as the expropriation of private property. In this sense, English common law is seen as a mechanism that protects contract rights and provides for efficient, well-controlled bureaucracies. Civil law however, stems from the French legal system, and was replicated by the Spanish and emphasizes the creation of a complete and powerful set of patrimonial bureaucrats and officials whose specific task was to control the population and the extraction of wealth from the colonies.

La Porta *et al*. (1998) believes that these laws in particular are detrimental to quality and performance of government as their social agenda is highly interventionist. The French legal system stimulates monopolies and resorts to control through obscure inefficient bureaucrats. The origins of legal traditions are important since they provide specific and deep-seated incentives for the construction of government and the relationship it enjoys with society.

Another important study that delves into the colonialist variable was carried out by Beck and Levine (2003) whose work also focuses on the roles of institutions, as well as legal traditions, and particularly their influence on the creation and operation of financial systems. Their analysis centers on the effect the origins of different legal systems have on the protection of private property, secure investment, honoring contracts and the rights of property owners. Beck and Levine (2003) argue that laws endorse a "political" mechanism when they define the relationship between governmental authority and private property. Legal traditions that limit this power are inclined to protect the financial development of companies and individuals, as in the case of the British legal system. The standpoint of the French legal system is different since it advocates that priority be given to the rights of government over those of private property holders. These authors clearly believe the British legal system is better suited to providing measures that protect property rights and ensuring contracts are honored.

Bates (2001) puts forward another interesting argument which focuses mainly on the relationship between prosperity and violence in East African countries. His paper attempts to understand the processes employed to delegate resources under the control of powerful elites and into private hands. This however, is not as simple as it sounds when we come to understand that delegation actually implies political struggle. Liberal institutions assume political competence and the decentralization of power. Developing countries it seems have not provided enough incentive to elites to enter this struggle, which has occasionally resulted in inequitable delegation processes. Even foreign investors have been reluctant to aid in the process since certain liberal institutions seek to limit the power of local elites, which in turn affects the prerogatives of this investment capital. Thus, creation of productive economic institutions has not been a priority among elites who hold on to power by maintaining a structure that limits economic incentives.

A completely different set of literature focusing on institutions is based on geographical variables (such as Mc Arthur and Sachs, 2001; Sachs, 2003; Rodrik, Subramanian and Trebbi, 2002). The first article by Mc Arthur and Sachs (2001) argues that geographical factors are important if we wish to understand the origins of the lack of development in certain countries. They propose three models: the first relates to the effects of the geographical factor on economic and legal institutions. The second model links the climate —or certain diseases— to the technology adopted to create certain kinds of institutions (for example, slavery versus free labor or predatory governments versus those that respect the rule of law). The last of the three models establishes that the growth of institutions is not only affected by geographical factors, but also by a diverse set of variables such as health, population growth and food production. The direct effects of geography on the healthy growth of institutions are evident in regions that experience regular outbreaks of diseases like malaria and low average levels of food production. Geography, then, affects the type of institutions a country chooses, which is critical in achieving suitable economic performance in developing countries.

Sachs (2003) similarly shows that there is a strong correlation between economic and demographic indicators and geographical and ecological variables (such as climate, disease and distance from the coast). These authors clearly find the impacts of geographical factors significant enough for them to be taken seriously in the development of more complex and formal models.

Some of these studies respond to arguments like that put forward by Rodrik *et al*. (2002), who suggest that the supremacy of institutions over such factors as geography or commerce is a variable that can be used to explain economic growth. Their model attempts to show that institutional variables enjoy greater weight in the results than geographical factors. Nevertheless, the general agreement is that institutions which protect property rights and respect the rule of law do in fact exist.

The most outstanding results of this study are that institutions are a determining factor for achieving productivity and accumulating capital whereas other variables (such as geography and commercial integration) do not affect these phenomena. In particular, institutions play a pivotal role in preventing the expropriation of property, which in turn provides an incentive to invest and accumulate tangible assets. Although commerce fails to influence growth directly, it is important to keep in mind that the authors have identified that this variable plays an indirect role on growth by affecting the quality of institutions. This means that the economic "openness" of a country is important in determining the type of economic institutions it chooses to create.

This brief review of the literature (see Appendix 1) gives us an overview on how the NIE has evolved towards a more complex analysis of the relationship between institutions, growth and democracy. Although the basic assumption remains the same (the "right" institutions are those that protect property rights and reduce transaction costs), it has become necessary to include historical and geographical elements which explain their construction. Moreover, this definition is deeply rooted in colonial domination and an interwoven structure of interests, as well as the fact that "perverse" institutions (Shyrley, 2003) are actually historical creations. Although this finding does not substantially change the recommendation regarding the need to construct "suitable" institutions, it has advanced in its understanding of the origins behind their creation and transformation in differing realities. Although path dependence is ever present (directly or indirectly) in the reviewed literature, it is actually quite surprising that the authors talk to us about "autarchic" political and economical elites. This is a significant limitation of the NIE approach.

3. How should developing countries build up political institutions better able to support efficient market institutions that lead to the consolidation of democratic regimes and stable economic growth?

The second question this literature has sought to respond to with respect to institutional design centers on the policy recommendations that would be needed for developing countries to attain institutions that favor market economies maintained within a democratic political regime. Accordingly, it is important that we understand the way in which these countries are able to change their institutions and determine which ones are most suited to achieving this objective. In this section we present recommendations arising from the studies we reviewed, which take into account the variables used to explain institutional and economic performance of developing countries. Generally speaking, our review of the literature suggests the majority of the authors all agree on the following aspects: *a)* the primary definition of institutions which serves as platform for research; specifically, that put forward by North (1990a) who understands institutions as a set of rules (otherwise known as "rules of the game") which regulate behavior and interaction between individuals; *b)* the importance of institutions in stimulating economic growth, with special emphasis on their quality. This variable is generally measured paying close attention to the guarantees afforded to property rights, and the limits and controls imposed on the power of governments (although its relative importance in comparison to other factors such as geography is under debate); and *c)* the lack of accurate recommendations on policy regarding the specific methodology for creating the institutions needed to encourage economic growth and the way in which existing institutions can be modified and transformed.

We agree with Jütting (2003) in that the literature remains "amazingly silent" with respect to the manner and extent of the adjustments necessary to transform institutions harmful to development into "successful" and "high quality" ones. In any case, there is no consensus on an institutional model that would ensure success. Nevertheless, some of the authors we looked at earlier have endeavored to make certain recommendations, albeit weak and generic ones.

Engerman and Sokoloff (2003) acknowledge that there is no single way to create institutions and that suitable economic performance can be obtained through alternative institutional structures. Nevertheless, and regardless of the institutional setting where they are found, they maintain that flexibility is vital in allowing society to take advantage of opportunities a changing environment might offer. These types of institutions are able to adapt, creating an atmosphere which stimulates innovation, generation of new technologies and, in turn, economic growth. From this perspective, institutions which would lead to economic growth need to be highly flexible and able to adapt to a competitive environment. Societies which enjoy these types of institutions can respond constructively to changes in the social, political and economic setting. Unfortunately, these ideas are still in their infancy and hardly point to specific recommendations for action with any measure of clarity.

Conversely, Rodrik *et al*. (2003) are well aware that their work is not a guide for designing policies that favor economic growth or development. As they themselves indicate, their emphasis lays in the importance of property rights; however, they remain unclear as to how these rights might be acquired. Moreover, they maintain that it is not possible to put forward a specific institutional design since any adjustments to them must perforce consider elements that encapsulate the exact context derived from historical trajectories, geographical factors, economic policy and other prevailing conditions in each country. Consequently, we agree with the authors when they say: "there is still much to be learned about what improving institutional quality means on the ground" (2003: 23).

Clague *et al*. (1997), on the other hand, do in fact present a number of precise recommendations, particularly related to economic policy. Firstly, they suggest that the package of stabilization-liberalization-privatization requires the support of the political class of a given country. Secondly, they recommend that developing countries must implement reforms that go beyond macroeconomic aspects. Indeed, what the authors are actually recommending is that successful market economies require rudimentary institutional structures: reliable public services, maintenance of the physical infrastructure, light governmental regulation, arenas in which to resolve enterprise disputes, and noninterference in the economy on the part of the government. In addition, these tasks must go hand-in-hand with greater changes in government bureaucracy and a more positive outlook towards privatization.

Shirley (2003), however, indicates that some of these recommendations are based on incorrect assumptions about institutional change; that institutions are malleable and able to change in the short term. Resultantly, these recommendations consider that external agents can easily detect the need for institutional change in a given country and thereby convince the government and other political actors to implement suggested reforms. In contrast, a great part of the literature, not to mention empirical evidence, highlights the inherent problems with these assumptions: *a)* institutional change is a process that usually involves 3 to 5 years of constant transformation, sometimes longer (15 or 20 years); *b)* institutional change requires alterations to beliefs and values, which cannot generally be observed by external consultants in such a relatively short timeframe; *c)* successful institutional change is often designed by internal agents to benefit a small elite group rather than the well-being of society as a whole; and *d)* the absence of strong institutional structures able to support the necessary change can lead to the suggested or imposed recommendations actually strengthening the positions of opposition groups through creating inappropriate incentives (Shirley, 2003). Lastly, other authors remain pessimistic and suggest institutional change is exceedingly difficult, if not impossible. This is the case of Acemoglu *et al*. (2000 and 2001) who insist that developing countries are often burdened by an existing set of powerful institutions inherited from colonial times that have been perpetuated through to the present day. This argument reflects the well-known "path dependence" theory of the NIE where existing local institutions (in this case inherited from colonialist practices of the past) resist economic development perpetuating low economic growth rates.

In summary, we have observed that the recommendations made by other authors are quite imprecise. Their work reflects an extremely vague interpretation of their findings, which are occasionally posed in a manner that is general and highly difficult to interpret. Consequently, this represents a further limitation when it comes time to spell out an agenda for reform in a particular country (Aron, 2000). It would be interesting to ask why this literature appears to be so underdeveloped from a methodological and prescriptive standpoint, yet at the same time remains so influential.

4. So where does the power lie?

Here we aim to identify some of the limitations of the institutional approach with the objective of opening the debate to other alternative forms of analysis, which perhaps go hand-in-hand with the institutional one. We can group these limitations into two categories; methodological matters on the one hand and conceptual aspects on the other.

The vast majority of the papers we reviewed used comparative methodologies between countries focusing mainly on measurements that endeavored to capture an institution's "quality". They employ a number of approaches to identify key "institutions" and measure their quality and performance. "Rule of law", "the risk of expropriation by the government" and "the security of property rights" are the core elements used in these types of studies (Aron, 2000). Aron goes further to suggest that the indicators used to measure an institution's "quality" comprise many different variables, which gives rise to three problems. Firstly, there is no consensus on which variables to include and which to leave out. Secondly, there is a risk of any explanation becoming tautological when the institutions are by (*ad hoc*) definition "high quality". Not only would it be necessary to state which institutions are needed (whether they be high quality or not), but also to specify the modifications required to achieve them. Lastly, measuring the impact of an institution's quality quite often employs indicators constructed from the perceptions of foreign investors and so-called "experts" [for example, the International Country Risk Guide (ICRG) and the Business Environment Risk Index (BERI)]. The problem with these indicators, says Aron (2000), is while they are adequate for studying developed countries, applying them to the study of developing countries is doubtful since they mainly focus on formal institutions, which may not be the most important institutions in developing nations.

Aron goes on to explain other difficulties with the method used to model and apply data in the reviewed literature. Firstly, collecting quality, reliable data can be problematic. There are the issues of omitting crucial variables, measurement errors, and the dilemma of reverse causality. Then there is one of the most significant limitations of all: explaining economic growth endogenously through institutions. A great deal of debate continues on whether "good" institutions generate economic growth or vice versa, that they themselves are the result of high rates of growth and economic development. Currently, there is no overall consensus on the direction of causality between institutional variables and economic growth.

This divergence grows wider still when we analyze the causality between democracy and growth. Unfortunately the findings have been inconclusive, especially since democracy exists and acts through several social channels each with its own consequences on growth. Transparency and accountability, which arise from democracies that improve economic performance, are considered to be positive political incentives whereas the need to reach a consensus in democratic institutions or the multiplicity of interest groups can have a negative affect on economic efficiency, delay the implementation of laws and standards or even prevent quick and effective responses to crises (Aron, 2000).

Then there are the conceptual limits of the institutional approach from which we point out a number of issues. Some for example have suggested that the very existence of democratic and market institutions is enough to explain high growth rates in certain political systems. However, this explanation assumes there is some type of automatic mechanism which is often absent in many developing countries (especially the new democracies in Latin America and East Europe where consolidation is ongoing) where these types of institutions are built up along a different logic. Lijphart and Waisman (1996) point out that different countries implement privatization and deregulation policies, as well as the opening up of their economies to competition following a logic of differentiation. These policies produce vertical as well as horizontal changes to the social setting; while the polarization of the rich and poor is often exacerbated, so too are the differences between the winners and losers within the same social class, between regions and finally, among countries. The consolidation of democracy, on the other hand, is based on the logic of mobilization. The new political scenarios that sprang up following the end of military dictatorships or the fall of the Soviet block have considerably reduced the cost of political action. This has opened up the political arena to those who were previously marginalized, excluded or otherwise relegated to political obscurity. Lijphart and Waisman (1996) have also recognized that this dynamic can be so intense and diverse at times that economic growth and consolidation of democratic regimes may even become contradictory phenomena, at least for a while.

Now perhaps is the time to move away from the argument centered on "*institutionalism*". No one doubts the importance of institutions, but they are not the only and most significant social explanation. As it turns out, it would be wise to complement this approach with the idea that institutions are part of a complex social process where interests and calculations are only part of the story. Indeed, it is no doubt necessary to push this argument to its limits and face its "anomalies" like all paradigms. The institutional paradigm inspired above all by the NIE needs to confront one of its most significant limitations: it is based on standardized ideas, which center on the assumption that "suitable", "correct", "good" and "rational" institutions exist (all these adjectives reoccur in the literature without further explanation, even in the writings of Douglass North, one of its creators). North (2005) in his more recent book states that institutions are socially embedded and thus form part of a social structure with multiple interpretations and meanings. Institutions then are created by different actors who face broad uncertainties (2005: 26). North goes on to specify the mechanisms that supposedly create "good" and "rational" institutions. His answer lies in a nation's cultural heritage and the way in which it provides a set of beliefs, tools and institutions that define our roles as players in the social arena. The richer the cultural structure of artifacts, the lesser the uncertainty, generating a kind of "creative competence" and experimentation making the survival of society more probable (2005: 36).

The primary assumption has been made clear: market and democratic institutions require well-defined property rights and reduced transaction costs. This means that the need for dynamics that support free exchanges have a simple and underlying explanation. "Good" institutions are exactly that because they generate a rich context of competition and experimentation which allows the actors to successfully face ubiquitous uncertainties in the long term. As a result, it is important that we see this argument through to its conclusion. Without further explanation, it would be inappropriate to simply keep assuming that only "good" institutions successfully create economic development and growth. Instead, they need to be evaluated in terms of their potential to create contexts and cultural devices that are "poorly" prepared to expand competition and experimentation, such as social attitudes and structurally supported values, despite them seeming rational in the eyes of certain actors.

It is evident then that there are other assumptions and axioms at play (the last of which immediately brings to mind Hayek, 1952). Nevertheless, we will not develop this discussion further in this paper. What is interesting for us now that we have accepted in principle the main argument linking institutions and economic growth are the underlying causes. Firstly, historical context and heritage are not the only important elements for institution building; cultural values and the meaning they lend a specific context are equally as important. Institutions are living, breathing creatures which are embedded in a network of social behavior and interactions. However, it is important that we continue to pursue this argument: if competition and the potential for social experimentation –products and substances of historically created cultural devices– are considered as key to understanding institution building in a given society then competition is directly related to the power relationships that have evolved in a particular historical context. This is because economic competition speaks purposefully about differentiated performance and achievement: some are better prepared and as a consequence, enjoy better results, which in turn lead to greater adaptation dominating a particular niche. Competition equates to struggle or battle between different actors and groups where there are winners and losers. It is only natural that winners would seek to maintain their dominance over the losers, employing the use of power tactics and strategies —as Foucault (2004) calls them— to do so. The NIE has a category that explains this, albeit generally: path dependence. However, path dependence is not only a "global" process that is only observable with high levels of abstraction. Path dependence implies that competition drives actors to become part of power structures and use strategies and tactics to maintain their advantageous position over time.

Competition implies inequality: in respect to capacity, opportunity, intelligence and ability; in other words, differentiation. Competition supposes that some individuals are better prepared to face a certain context than others and this difference is the key to social achievement. Competition means that winners and losers are a "natural" part of the struggle for survival or, in other words, to cope better with a certain context. Hence we can refer to competition as a concept that is intimately related to the power variable. Not only is an institution the result of certain types of interactions, but also in part the product of a power struggle between actors looking to build and legitimize certain "meanings" for action and decision-making.

From our prespective, introducing the power variable into studies relating growth with institutions and democracy seems both promising and productive. First of all, it would allow us to see path dependence as a critical element in explaining the nature of a country's institutions and, moreover, understand the complex resistance on the part of actors to modifying these surroundings.

Additionally, it would enable us to introduce a series of important variables into our econometric regressions, apart from those already developed, or at the very least complement those pertaining to institutions. What is more, we should seek out and build up data bases on variables such as the weight and importance of the role of international actors in supporting institutions in developing countries. And not only in its more evident route: that institutions of the developing countries are part of an internal and external framework of interests. It also would allow us to identify critical moments in a developing country's history where external political and economic interests have acted and continue to act systematically to curtail profound changes in the institutional settings of these nations. This will make it possible for us to run econometric regressions relating development and institutions to the degree of power and influence of international economic and political interests.

Power is an elusive category, no doubt about it. Creating variables and data bases related to this concept would be a difficult, albeit rewarding task indeed. We have seen how the economic, political and geographic variables currently used to study today's institutions are very limited. Adding power variables would be a small step toward understanding, which will also require us to develop new perspectives and data. Moreover, the term itself is problematic, but perhaps it would be a good idea to begin with a broad and far-reaching meaning of the concept. Power is not an attribute actors enjoy, but a cause and effect relationship. As Lukes (1985) explains in his classic study: "power is not one-dimensional ('A' has power over 'B'). It is also bi-dimensional in nature and implies the capacity to establish a framework of 'valid' and 'possible' options, which are considered by society, and suppressing certain others making non-decision possible" (Bachrach and Baratz, cited in Lukes, 1985: 16). The link between this argument and that surrounding institution building is obvious. A bi-dimensional or even three-dimensional concept of power, such as the one Lukes proposes, would make an interesting departure point indeed for the analyses we propose.

Introducing this variable would not only make it necessary to consider the exogenous interferences on institutional design and building in developing countries, but perhaps also to discuss once more the international distribution of power (international division of labor as some would say). Perhaps it would be enlightening to reread the dated "dependence theory" put forward by Samir Amin (1980) and later by Falleto (1999) in greater detail, which characterizes competition as a struggle or battle where the euphemisms of "market" and "competition" need to be dissected in order to study the actual actors and the tactics and strategies they use to create long-lasting institutions that meet their own interests or points of view [to embed the market in social structures (Granovetter, 1985)].

It would be interesting to know how the institutional theory would stand up in a hypothetical scenario in which the international division of labor implies a strong restriction to fair and equitable development and growth of different nations and where differing patterns for the distribution and correlation of power define the possibilities for competition. If this scenario turns out to be true at least in part, it would mean that institutional analysis should discuss the "rules of the game" in the international arena, as well as the distribution of roles and wealth, technology and innovation. Analyses like this would better equip us to understand how powerful actors and their interests create and manipulate the argument of path dependence in order to perpetuate their own socioeconomic advantage (within, between and across countries).

We are aware of the difficulties this project poses, in particular with the methodology it employs. Our idea is to first apply the power variable and then the influence of international actors as a complementary variable to the debate of democracy and development within the institutional settings. In any case, by including the power variable we need to take great care that we do not make the same mistakes we have criticized here, that is, establishing it as the dominant variable excluding all others. Our aim is to strengthen the institutional paradigm by complementing the traditional variables and in so doing, lead us to more realistic and useful policy recommendations. One thing is for sure, the recommendations we may arrive at will be neither simple nor easy, but perhaps less standardized and more productive in the long run.

5. Making power and institutions operative: path dependence

We propose to introduce the power variable through the operative concept otherwise known as path dependence. Obviously, path dependence is often looked upon as a power "tactic", which is just one part of this complex phenomenon. It is however, an interesting concept as it helps to explain how actors jealously guard certain institutional arrangements in order to maintain their privileged position. According to studies on institutions and growth, path dependence can be determined not only by internal elites, but by actors outside the country as well. As a result, institutional design is not just a sovereign act carried out by local elites, but a complex process of negotiation and struggle between different groups both within and outside the country. The idea then is to add measures so that we can demonstrate how the efforts of international actors sustain certain aspects of path dependence affecting institutional settings and impacting on economic growth.

This first attempt at measuring the power variable will focus on economic path dependence. In other words, we will use economic variables that potentially affect economic growth and might also be important in understanding how the institutions that critically affect the economic landscape of a country are built. Specifically, we will attempt to show that economic growth in Latin America (from 1970 to 2003) is related to significant economic variables which in turn are decisive for the development of important institutional settings within those countries. We built a panel data model for 16 Latina American countries (representing 80% of the GPD in the region).[1] We present our methodology and more detailed tables of results in appendix 2.

This current stage of our research uses two channels to study economic path dependence in these countries: international market capital and the exchange of goods and services. The first considers three financing mechanisms: *1)* public external debt, *2)* direct foreign investment, and *3)* IMF loans. By using these variables we seek to build up a proxy that explains the impact of these external elements on the amount of leeway a country might have to develop its own institutions and foster change. The gross assumption is that transforming local institutions in order to produce this theoretical virtuous circle of democracy and the market would affect the interests of important players and change the rules of the game related to exchange and production. Therefore, how much maneuvering ground can a country boast if it is tied to powerful economic interests from abroad (bankers, transnational companies and countries)? How much room for maneuvering is there when loans granted to solve financial crises are structured to ensure their repayment rather than growth? With respect to goods and services, we agree with Rodrik *et al*. (2002) when they suggest that trade (even international) has a significant impact on the quality of institutional settings and that the way a country defines its degree of openness to trade may come to determine the types of institutions built in a particular country. In other words, what an economy exports or imports is not always representative of sovereign decision making, but rather an expression of the pattern of interests (both internal and external) which struggle to define and sustain a specific "mix" of goods and services that are produced and launched to "compete" in international markets. This is why we use a simple measure of commercial openness: the percentage of imports and exports in relation to the total balance of trade. We are very clear that we are developing broad and obscure assumptions using these variables. Moreover, we recognize that they are not single-effect variables in that they are likely to affect institutions in not one, but a number of different ways. At the current stage of this research, we decided to take the chance keeping in mind that our task is to make a case for the importance of introducing path dependence variables, even though their measurement may be very complicated indeed.

Additionally, we add two exogenous variables as controls: one demographic and the other political in nature. The first uses population in millions while the second is a dummy which takes the value of 1 when a

[1] The countries included are: Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Paraguay, Peru, Uruguay and Venezuela.

democratic setting is in place. They are both exogenous to our model and have an indirect impact on economic growth.

The economic variables are drawn from the World Development Indicators 2006 of the World Bank (in constant dollars base 2000 = 100). The demographic variable is taken from the same source and the dummy (democracy) was constructed from the work of Peter Smith (2004).[2]

As we have mentioned, our estimate employs a "pool" type panel data model (without fixed effects). The following equation represents our estimated model:

(1)

$$\ln gdp = \alpha + \beta_1 \ln population + \beta_2 Democracy + \beta_3 \ln IMF + \beta_4 \ln FDI + \beta_5 \ln EXDEBT + \beta_6 OpennessMeasure + \varepsilon$$

Where, ln*gdp* is the logarithm of the GDP, ln*population* is the logarithm of the number of inhabitants, *Democracy* is a dummy (where a value of 1 represents a democratic environment and a value of 0 represents a non-democratic environment), ln*IMF* is the logarithm of the amount of IMF loans, ln*FDI* is the logarithm of the Foreign Direct Investment, ln*EXDEBT* is the logarithm of public external debt, and the *Measure of Openness* is constructed by the ratios of exports and imports in relation to the balance (Exports/openness is equal to Exports/(Exports + Imports), and Imports/openness is equal to Imports/(Exports + Imports)). In the case of the variables expressed in logarithm, the coefficients represent the elasticity of each independent variable in relations with the dependent one. In the case of the trade exchange (not expressed in logarithm) its coefficient shows the marginal effect of these variables on growth.

The results can be found in this table after correcting for endogeneity problems (see Appendix 2):

[2] Smith (2004) analyzes the case of Latin America using four types of democratic environments: "democratic", "semi-democratic", "oligarchic" and "non-democratic". Consequently, the dummy variable we use takes on a value of 1 in a "democratic" environment and zero in the others.

TABLE 1. RESULTS OF THE ESTIMATION

	1	2	3	4
	EXPORTS /OPENNESS		IMPORTS /OPENNESS	
INSTRUMENT	LAGS LNGDP	RESERVES LNGDP	LAGS LNGDP	RESERVES LNGDP
LNPOP	0.721 [0.044]***	0.924 [0.125]***	0.721 [0.044]***	0.924 [0.125]***
DEM	-0.103 [0.048]**	-0.667 [0.241]***	-0.103 [0.048]**	-0.667 [0.241]***
LNFMI	-0.003 [0.003]	0.112 [0.045]**	-0.003 [0.003]	0.112 [0.045]**
LNFDI	-0.024 [0.010]**	-0.055 [0.024]**	-0.024 [0.010]**	-0.055 [0.024]**
LNEXDEBT	0.456 [0.033]***	0.171 [0.133]	0.456 [0.033]***	0.171 [0.133]
EXPSHAREOPP	0.018 [0.003]***	0.013 [0.006]**		
IMPSHAREOPP			-0.018 [0.003]***	-0.013 [0.006]**
CONSTANT	1.47 [0.336]***	5.391 [1.683]***	3.253 [0.400]***	6.66 [1.587]***
OBSERVATIONS	528	528	528	528
ADJUSTMENTS R-SQUARED	0.91	0.58	0.91	0.58

Standard errors in brackets
* significant at 10%; ** significant at 5%; *** significant at 1%

Panel 1 and 2 show the results of the regression using the ratio between exports and the balance of trade as a measure of openness. In panel 1 we use the first lags of every potentially endogenous variable as instruments and in panel 2 we use the amount of international reserves as a variable to deal instrumentally with the IMF variable (and first lags for the other potentially endogenous variables). We applied the same logic in panel 3 and 4, but the difference with panel 1 and 2 is that the measure of openness is represented by the ratio between imports and the balance of trade.[3]

The results need to be taken carefully: we are in an exploratory phase of the study and we do not want to rush to any conclusions with such limited evidence. The interpretations that follow are cursory to determine whether a plausible relationship might be inferred.

Firstly, population seems to have a significant yet positive impact on growth, independent of openness and IMF variables. A 1% change in population rate impacts 0.72% and 0.92% respectively on GDP, depending on the instrumental variables used.

[3] As we mention in Appendix 2, the instrumental variables are incorporated into the model to avoid endogeneity problems affecting the results of our estimation.

The dummy (Democracy) shows a significant, but negative impact on growth independent of the commercial openness and instrumental variables used by the IMF. These results imply that a democratic environment generates a negative dynamic for growth [as already suggested by some authors such as Barro (1996)]. A democratic environment might make it harder to transform institutions built up to protect diverse interests, affecting efficiency or simply preventing implementation of critical changes to institutions, as mentioned by Aron (2000).

Regarding the economic path dependence represented by international markets, first of all we have to mention that the IMF loans in our estimation show contradictory results. You can see in panel 1 and 3 that their effect over growth is negative (a 1% growth in loans causes a reduction of 0.003% in GDP); however, this is not significant whereas in panels 2 and 4, IMF loans have a significant yet positive affect. Evidently the difference between these results depend on the type of instrument used making us think that the IMF has an impact on growth, but we will need to construct better proxies if we want to understand this effect better.

The second component we used to observe the effects of international capital markets on growth (looking to capture economic path dependence) was the level of foreign investment directly entering a country. The effects of this variable do not change in relation to the instrument used: the FDI has a negative and significant impact on growth (an increase of 1% in FDI has a negative affect on growth of 0.024% and 0.055% respectively depending on the instrument used). This might suggest that FDI is a dynamic expression of external interests which influence the definition of institutions in the host country in order to keep certain patterns that are convenient to the foreign investor and not necessarily the host nation. Obviously, this is a very complex variable; however, we think it might be plausible to think that, to some degree at least, path dependence here is important in explaining this effect.

The last variable is external public debt. The results show that the significance of this variable is different depending on the instrument used (the coefficients are significant in panels 1 and 3, but not in panels 2 and 4). However, the direction of the effect is one-way: external public debt has a positive impact on growth. This finding suggests that external public debt is crucial in order to make the economy of these countries grow. As a complex variable, however, it is quite possible to believe that a country might become more vulnerable as a result of its dependence on external debt. Following this variable as a path dependence proxy in the future might also be interesting.

In terms of commercial openness, the results show that the percentage of exports with respect to the balance of trade have significant and positive effects, regardless of the variables used to instrument IMF loans. In the case of imports, the effect is significant, but negative. (The coefficients of these variables are a "mirror" as a result of their construction.) In terms of path dependence, our findings suggest that there is an important clash of interests between exporters and importers. The way in which a country might be influenced to affect the balance of its imports and exports seems to be important if we want to understand the international division of labor.

Despite its limitations, we can see that this first attempt at measuring path dependence is somewhat promising. We have developed a model that makes bold assumptions regarding complex processes. However, we are optimistic that we have been able to demonstrate that the debate on institutions needs to face up to the fact that institution building and design is actually a process and not an isolated or discrete rational act of certain actors. It is a process that involves complex interactions between elites and other groups within a country, as well as groups abroad with important and differing interests. Moreover, it is an historical process where stronger nations continue to play an important role in the design and maintenance of institutions in their former colonies. Nowadays however, this relationship appears to be much more complex. Path dependence does not simply arise out of the political arena between states, but instead involves the intervention of companies, international organizations and networks of actors as well. If we are able to show in future studies that path dependence is indeed an expression of the struggle that different actors undergo to maintain certain institutions and conditions which assure them profit and to preserve influence and domination over certain countries and their policies then we will be advancing this debate. Our main objective is to elevate this debate above and beyond institutions to one that is less standardized and more realistic where responsibilities and policies need to be reassigned to include a broader spectrum of actors rather than just elite groups of the governing classes in developing countries.

This research is still in its infancy and as a result it is urgent that a new set of data be built up. We should also point out that our efforts seek to complement institutional analysis, not displace it. If we can demonstrate that the introduction of these path dependence variables (as proxies of what we call power) are able to give us significant coefficients and correlations as powerful (or limited) as those that have been used by the NIE literature on economic growth, then perhaps we will be able to make a case for the introduction of new variables along more realistic, complex and useful lines rather than the standard and linear relationships between institutions and economic growth.

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APPENDIX 1. THE NIE LITERATURE REVIEWED

AUTHOR	METHOD	DEPENDENT VARIABLE	INDEPENDENT VARIABLES
NORTH (1990)	QUALITATIVE ANALYSIS	INSTITUTIONAL PERFORMANCE & ECONOMIC GROWTH	HUMAN MOTIVATION & CAPACITY TO DECODE THE ENVIRONMENT. INCENTIVES DESIGN
CLAGUE ET AL. (1997)	QUALITATIVE ANALYSIS	ECONOMIC GROWTH	PROPERTY AND CONTRACTUAL RIGHTS
ACEMOGLU ET AL. (2000)	ECONOMETRIC ANALYSIS (CROSS-COUNTRY)	GDP PER CAPITA	COLONIAL LEGACY. EXTRACTORS STATES VERSUS NEO-EUROPEAN STATES
ACEMOGLU ET AL. (2001)	ECONOMETRIC ANALYSIS (CROSS COUNTRY)	"REVERSAL OF FORTUNE"	COLONIAL LEGACY. INSTITUTIONAL REVERSION
ENGERMAN AND SOKOLOFF (2003)	ECONOMETRIC ANALYSIS (CROSS-COUNTRY)	ECONOMIC GROWTH	COLONIAL LEGACY. NATURE & STRUCTURE OF THE POLITICAL POWER
ENGERMAN AND SOKOLOFF (2005)	ECONOMETRIC ANALYSIS (CROSS-COUNTRY)	ECONOMIC DEVELOPMENT	COLONIAL LEGACY. PRODUCTION FACTORS ENDOWMENT
LA PORTA ET AL. (1998)	ECONOMETRIC ANALYSIS (CROSS-COUNTRY)	GOVERNMENTAL QUALITY	COLONIAL LEGACY. LEGAL TRADITIONS
BECK AND LEVINE (2003)	LITERATURE REVIEW	FINANCIAL SYSTEM DEVELOPMENT	COLONIAL LEGACY. LEGAL INSTITUTIONS
BATES (2001)	QUALITATIVE ANALYSIS	POLITICAL FUNDAMENTS OF ECONOMIC DEVELOPMENT	POLITICAL CONFLICTS. PROSPERITY & VIOLENCE
MCARTHUR AND SACHS (2001)	ECONOMETRIC ANALYSIS (CROSS-COUNTRY)	ECONOMIC DEVELOPMENT	GEOGRAPHIC FACTORS
SACHS (2003)	ECONOMETRIC ANALYSIS (CROSS-COUNTRY)	ECONOMIC GROWTH	GEOGRAPHIC & ECOLOGICAL FACTORS
RODRIK ET AL. (2002)	ECONOMETRIC ANALYSIS (CROSS-COUNTRY)	GDP PER CAPITA	INSTITUTIONAL QUALITY
ARON (2000)	LITERATURE REVIEW	ECONOMIC GROWTH	INSTITUTIONAL ENDOWMENT
JÜTTING (2003)	LITERATURE REVIEW	ECONOMIC GROWTH	INSTITUTIONAL DESIGN
SHIRLEY (2003)	LITERATURE REVIEW	ECONOMIC DEVELOPMENT	INSTITUTIONAL DESIGN

APPENDIX 2. ANALYSIS METHODOLOGY

Our econometric analysis is based on the construction of a panel containing 16 Latin American countries from the period 1970-2003 in an attempt to explain economic growth. We have included the following countries:

1. Argentina
2. Bolivia
3. Brazil
4. Chile
5. Colombia
6. Costa Rica
7. Dominican Republic
8. Ecuador
9. El Salvador
10. Guatemala
11. Honduras
12. Mexico
13. Paraguay
14. Peru
15. Uruguay
16. Venezuela

The model we propose is the following:

(1)

$$\ln gdp = \alpha + \beta_1 \ln population + \beta_2 Democracy + \beta_3 \ln IMF + \beta_4 \ln FDI + \beta_5 \ln EXDEBT + \beta_6 OpennessMeasure + \varepsilon$$

Where, *ln(gdp)* is the logarithm of the GDP, *ln(population)* is the logarithm of the number of inhabitants, *Democracy* is a dummy (where a value of 1 represents a democratic environment and a value of 0 represents a non-democratic environment), *ln(IMF)* is the logarithm of the amount of IMF loans, *ln(FDI)* is the logarithm of the Foreign Direct Investment, *ln(EXDEBT)* is the logarithm of public external debt, and the *Measure of Openness* is constructed by the ratios of exports and imports respect the commercial balance [Exports/openness is equal to Exports/(Exports + Imports), and Imports/openness is equal to Imports/(Exports + Imports)].

Our economic data mainly comes from the *World Development Indicators 2006* of the World Bank (we use constant dollars, year 2000 = 100) and the dummy is constructed from the work of Peter Smith (2004).

The descriptive statistics of our variables are presented in the following table:

TABLE A2.1. DESCRIPTIVE STATISTICS

VARIABLE	MEAN	STD. DEV.
GDP (MILLION 2000 USD)	84,768.64	140,601.50
POPULATION (MILLION)	23.83	35.85
AMOUNT OF LOAN FROM IMF (MILLION 2000 USD)	193.47	1,035.54
FOREIGN DIRECT INVESTMENT (MILLION 2000 USD)	1,407.05	3,766.96
EXTERNAL DEBT (MILLION 2000 USD)	30,019.92	48,344.95
DEMOCRACY	0.70	0.46
INTERNATIONAL RESERVES (MILLION 2000 USD)	5,916.63	9,328.47
EXPORTS /OPENNESS	46.92	9.48
IMPORTS / OPENNESS	53.08	9.48
NUMBER OF OBSERVATIONS	544	

As we have mentioned before, our estimate employs a "pool" type panel data model (without fixed effects) using an Ordinary Least Square (OLS) method. Given our dependent variable and the independent variables we have selected, our model has presented endogenous problems between the *ln(GDP)* and four variables: IMF, FDI, EXDEBT and Measure of Openness. These problems have arisen because some of the variables are direct components of GDP (IMF and EXDEBT) whereas others are the outcome of fluctuations in our dependent variable. Conversely, we have not considered that Population and Democracy are endogenous variables.

In order to solve this problem, we used instrumental variables and we estimated our model (1) with an OLS in two stages (2SLS) that run a lineal regression model in two "phases". We estimate an OLS regression in the first where the dependent variables are the potentially endogenous variables and the explicative variables are the set of proposed instruments and exogenous variables of the model. In the second stage, the 2SLS method used the estimation results of every endogenous variable (obtained from the previous stage) in order to estimate again the original model (1) using an OLS method.

The main instruments we have selected are the temporal lags of endogenous explicative variables. We chose these instruments because we supposed that there was a weak temporal correlation between the dependent variables and the estimator lags. Following Barro (2002) we used another instrument to solve the endogenicity problem within the IMF variable: the amount of international reserves (in logarithm) of the sixteen selected countries. We chose international reserves because they are one of the main determinants of the use and amount of loans granted by this international body.

The following table shows our results:

TABLE A2.2. ESTIMATION RESULTS

	1	2	3	4
	EXPORTS /OPENNESS		IMPORTS /OPENNESS	
INSTRUMENT	LAGS LNGDP	RESERVES LNGDP	LAGS LNGDP	RESERVES LNGDP
LNPOP	0.721 [0.044]***	0.924 [0.125]***	0.721 [0.044]***	0.924 [0.125]***
DEM	-0.103 [0.048]**	-0.667 [0.241]***	-0.103 [0.048]**	-0.667 [0.241]***
LNFMI	-0.003 [0.003]	0.112 [0.045]**	-0.003 [0.003]	0.112 [0.045]**
LNFDI	-0.024 [0.010]**	-0.055 [0.024]**	-0.024 [0.010]**	-0.055 [0.024]**
LNEXDEBT	0.456 [0.033]***	0.171 [0.133]	0.456 [0.033]***	0.171 [0.133]
EXPSHAREOPP	0.018 [0.003]***	0.013 [0.006]**		
IMPSHAREOPP			-0.018 [0.003]***	-0.013 [0.006]**
CONSTANT	1.47 [0.336]***	5.391 [1.683]***	3.253 [0.400]***	6.66 [1.587]***
OBSERVATIONS	528	528	528	528
ADJUSTMENTS R-SQUARED	0.91	0.58	0.91	0.58

Standard errors in brackets
* significant at 10%; ** significant at 5%; *** significant at 1%

Panel 1 and 2 show the regression results using as a measure of openness the ratio between exports and the balance of trade. In panel 1 we used the first lags of every potentially endogenous variable as instruments, and in the panel 2 we used the amount of international reserves as a variable to instrumentalize IMF loans (and first lags for the other potentially endogenous variables). In panel 3 and 4 we used the same logic, but the difference between panel 1 and 2 is that the measure of openness is represented by the ratio of imports to the balance of trade.

In order to evaluate whether the selected method (2SLS) solved the endogeneity problem we performed a Hausman test. This test detects measurement errors using the consistency and asintotic efficiency property of the OLS estimators.[4] According to this test, the OLS and the instrumental variables estimators are consistent but the second one is less efficient. The null hypothesis says that the OLS estimators and the 2SLS estimators are consistent. The alternative hypothesis is that the OLS estimators is

[4] We talk about consistency when the limit probability of regressor converges to the population parameter with efficiency meaning that the variance of the regressor is minimal.

inconsistent and asintotically efficient. The difference between OLS and 2SLS regressors is given by:

$$q = \beta_{iv} - \beta_{ols}$$

Then, the asintotic test for the null hypothesis is expressed by:

$$\frac{q^2}{\mathrm{var}(\beta_{iv}) - \mathrm{var}(\beta_{ols})} \sim \chi^2(1)$$

According to this test, when we accept that the 2SLS regressors are consistent, then they are better estimators than those that do not have this property [see Johnston and Dinardo (1997) and Greene (2000)].

The following table shows the results of the Hausman test (statistics and their probability) and these results suggest that our use of instruments improves the estimation and the consistency of the selected parameters.

TABLE A2.3. THE HAUSMAN TEST RESULTS

Espec	1	2	3	4
chi2(6)	14.2	7.5	14.2	7.5
Prob>chi2	0.0275	0.2771	0.0275	0.2771

These results show that we reject the null hypothesis (both estimators are consistent) whereas we cannot reject the alternative hypothesis (the OLS estimators are not consistent). Therefore, we should use instruments because they are more consistent.

Fixed effects in model (1)

To complement our analysis, we attempted to discount the impact of different macroeconomic scenarios during the last thirty years. In other words, we control for time, estimating the model (1) including time fixed effects. The results are shown in the following table:

TABLE A2.4. FIXED EFFECTS

	1	2		3	4
	EXPORTS/OPENNESS			IMPORTS/OPENNESS	
INSTRUMENTS	LAG LNGDP	RESERVES LNGDP		LAG LNGDP	RESERVES LNGDP
LNPOP	0.57 [0.043]***	0.363 [0.090]***		0.57 [0.043]***	0.363 [0.090]***
DEMSH	0.017 [0.050]	0.061 [0.091]		0.017 [0.050]	0.061 [0.091]
LNFMI	-0.019 [0.004]***	-0.129 [0.025]***		-0.019 [0.004]***	-0.129 [0.025]***
LNFDI	-0.033 [0.009]***	-0.025 [0.017]		-0.033 [0.009]***	-0.025 [0.017]
LNEXDEBT	0.621 [0.034]***	0.885 [0.082]***		0.621 [0.034]***	0.885 [0.082]***
EXPSHAREOPP	0.022 [0.002]***	0.029 [0.005]***			
IMPSHAREOPP				-0.022 [0.002]***	-0.029 [0.005]***
CONSTANT	0.06 [0.329]	-2.602 [0.819]***		2.269 [0.376]***	0.29 [0.797]
OBSERVATIONS	528	528		528	528
NUMBER OF YEARS	33	33		33	33

Standard errors in brackets
* significant at 10%; ** significant at 5%; *** significant at 1%

Introducing fixed effects means that if the estimators coefficient do not change substantially in respect to our original model (1) then the time variable does not have a structural impact on the level of GDP and therefore, on economic growth. It is interesting to note that the only estimators that change when we control for time are the loans granted by the IMF: independent of the measures of openness and the instrument used, this variable is always significant and it has a negative effect on GDP and economic growth.

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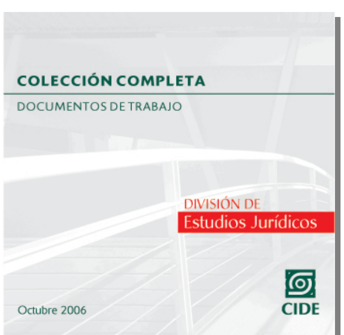

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