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

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Abstract

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.

growth - institutions - openness - geography

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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 “wants” 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.

Keywords: growth, institutions, openness, geography

JEL classification: F1, N7, O1

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.

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