Review of: "Institutions and Socioeconomic Development: Do Legacies and Proximity Matter? Case Studies of Indonesia, the Philippines, and Thailand"

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REVIEW of the paper by Muyanja-Ssenyonga Jameaba[1], Ely Susanto[1]

Institutions and Socioeconomic Development: Do Legacies and Proximity Matter? Case Studies of Indonesia, the Philippines, and Thailand

The authors do not find a conclusive pattern of relationship between democracy, institutional capacity and well-being indicators. Their conclusion is that

«correlation results in the three countries, Indonesia, the Philippines, and Thailand, showed that rule of law, political stability and absence of violence, human development index, and competitiveness and control of corruption have a positive and strong association with government effectiveness. For Indonesia, the state of human development is hampering democracy (negative association), while higher democratization seems to be associated with a decline in the business climate in the archipelago nation. The Philippines shows similar results with the human development index and doing business performance showing an inverse relationship with democratization. In the case of Thailand, competitiveness and government effectiveness have an adverse influence on democracy».

There are two possible explanations for the lack of straightforward relationship.

1. Many subjective indices of institutional quality, including World Bank Governance Indicators (WGI) are based on expert estimates that are often biased and contradict objective measures (Popov, 2011). According to a narrow definition, the state's institutional capacity is the ability of the government to enforce laws and regulations. Two logical objective measures of state institutional capacity are murder rates—noncompliance with the state's monopoly on violence —and the shadow economy—non-compliance with its economic regulations, including monopoly on taxation.

In principle, crime rate—non-compliance with all state laws—would be a better indicator than the murder rate. However, crimes are registered differently in different countries. Higher crime rates in developed countries seem to be the result of better registration of crimes. In contrast, grave crimes, like murders, appear to be registered quite accurately even in developing countries, so international comparison of murder rates is warranted.

As for shadow economy, estimates are not very reliable, but at least they are not subjective: they are derived from comparisons between official output and variables closely tied to output but believed to be registered better than output (energy and electricity consumption, transportation activity, tax revenues, employment, demand for real cash balances). Estimates of the shadow economy derived by each of these methods vary a great deal but presumably reflect some real phenomena.

Differences between country rankings based on subjective measures (for instance, government effectiveness index) and objective measures (murder rate and shadow economy) are significant. The subjective index of government effectiveness is measured on a scale of -2.5 to +2.5; the higher the score, the greater the government effectiveness. East Asia and Middle East and North Africa states do not get the same high rankings in government effectiveness as they do in their ability to contain the murder rate and the shadow economy. Moreover, though one might expect the share of the shadow economy to be lower in states with better institutional capacity, this turns out not to be the case. When the subjective indices of institutional capacity are adjusted for GDP per capita, there is no correlation whatsoever between these indices and the objective measures (shadow economy and murder rate). In fact, none of the subjective indices (corruption perception, investment climate, rule of law, or government effectiveness) helps explain the share of shadow economy in GDP after controlling for the level of GDP per capita. This is very much against intuition and raises serious concerns about the quality of these subjective indices.

Besides, it appears that **political regime (democratic or authoritarian) matters for the subjective ranking. It could be shown, for instance, that out of two countries with the same murder rate, government effectiveness is higher in countries that were more democratic in the past (1970s - 1990s on average) and in the year 2002 when government effectiveness was measured.** This result holds for all other five WB subjective indices of institutional capacity – rule of law, control over corruption, voice and accountability, political stability and regulation quality. And they hold also for the share of shadow economy: out of two countries with the same share of shadow economy, government effectiveness is higher in a more democratic one.

Concrete examples help provide a clearer picture. The murder rate in China, for instance, in the early 2000s is less than three persons per 100,000 inhabitants—one of the best records in developing countries. As well, China's shadow economy is less than 17 percent of GDP, lower than in Belgium, Portugal, and Spain, whereas in developing countries it is typically around 40 percent, sometimes even over 60 percent. Few other developing countries have such a low share of shadow economy (the exceptions being Vietnam and some MENA states like Iran, Jordan, Saudi Arabia, and Syria). However, in terms of government effectiveness, China (0.1) is close to Panama (-0.1), which has a murder rate of 19 people per 100,000 inhabitants and a shadow economy that makes up over 60 percent of GDP (Popov, 2011).

1. The relationship between democracy and wellbeing is not linear. Zakaria (1997) looks at the rise of "illiberal democracies" - countries, where competitive elections are introduced before the rule of law is established. While European countries in the XIX century and East Asian countries recently moved from first establishing the rule of law to gradually introducing democratic elections (Hong Kong before and after handover to China in 1997 is the most obvious example of the rule of law without democracy), in Latin America, Africa, and now in many former Soviet Union countries democratic political systems were introduced in societies without the firm rule of law. Authoritarian regimes (including communist), while gradually building property rights and institutions, were filling the vacuum in the rule of law via authoritarian means (lawless order). After democratization occurred and illiberal democracies emerged, they found themselves deprived of old authoritarian instruments to ensure order, but without the newly developed democratic mechanisms (rule of law) needed to guarantee property rights, contracts and order in general.

We (Polterovich, Popov, 2005) tried to test this relationship using the dataset on democracy from the Freedom House and on institutional capacity indices and corruption from Transparency International and World Bank. There were two innovations as compared to the previous literature on democratization and growth. First, not only the level of democracy was taken into account, but also changes in this level in the 1970s-1990s as measured by the political rights indices of the Freedom House. Second, the distinction was made between the rule of law and democracy, the rule of law being defined as the ability to ensure order based on legal rules; it was measured by the rule of law, investors' risk and corruption indices. It was found that **democratization in countries with strong rule of law (liberal democracies) stimulates economic growth, whereas in countries with poor rule of law (illiberal democracies) democratization undermines growth. In illiberal democracies institutions are weaker, shadow economy is larger and macroeconomic policy is less prudent**[1].

Hence, it is appropriate to distinguish between liberal democracies – strong democratic regimes (OECD), liberal and liberalizing autocracies – strong authoritarian regimes (East Asia before 1990s, China and Vietnam today) and illiberal democracies – weak democratic regimes (most countries in SSA, South Asia, LA). The former two are politically liberal or liberalizing, i. e. protect individual rights, including those of property and contracts, and create a framework of law and administration, while the latter regimes, though democratic, are politically not so liberal since they lack strong institutions and the ability to enforce order (Zakaria, 1997). The most efficient institutions are found in countries with the strong rule of law maintained either by democratic (OECD countries today) or authoritarian regimes (XIX century Europe, postwar East Asia). The least efficient institutions are in illiberal democracies combining poor rule of law with democracy (South Asia, Latin America, Sub-Sahara Africa, CIS – Commonwealth of Independent States). Illiberal autocracies – less democratic regimes with weak rule of law (Middle East and North Africa – MENA) appear to do better than illiberal democracies in maintaining institutional capacity.

The process of democratization is associated with little costs and many benefits, if carried out in liberal autocracies, i.e. in countries that have already created a system of protection of civil rights (except for political rights), or, to put it differently, established mechanisms and traditions for the rule of law. But when democratization occurs in illiberal autocracies, i.e. in countries that maintain order, but not based on law, the result is the emergence of illiberal democracies, whose record in ensuring institutional capacities is the worst, which predictably has a devastating impact on economic growth.

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It would be interesting to see to what extent this general scheme is applicable to three countries in question (Indonesia, the Philippines, Thailand). The share shadow economy and the murder rate are higher in the Philippines and Thailand than in Indonesia (murder rate per 100,000 in 2019, Philippines – 13.9, Thailand – 5,8, Indonesia – 0.9). Shadow economy in 1991-2003 as a % of GDP: Indonesia – 23-27%; the Philippines – 41-45%; Thailand – 50-56% (Medina, Schneider, 2018). Meanwhile, the WB governance indicators are not that different (https://info.worldbank.org/governance/wgi/).

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[1] The typical regression equation with all variables significant at 5% level or less was:

GROWTH= CONST. + CONTR.VAR. + D*(0.18RofL – 0.13), where

GROWTH - average growth rate of GDP per capita in 1975-99,

D – democratization (change in democracy index in 1970-2000),

RofL – rule of law index. The critical level of the rule of law index was 0.72 (more than in Czech, Jordan, Malta, Uruguay; but less than in Cyprus, Estonia, Hungary, Slovenia, Tunisia): if the index was higher, democratization had a positive effect on growth, if it is lower, the impact was negative.