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Transitioning Democracies are a Risky Business in the South

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Abstract

The paper finds that trade is insignificant in explaining income inequality. The results also suggest institutions are good for inequality mitigation for a larger sample of developed and developing countries. Though, the results do not change for some institutions like rule of law when the sample is restricted to developing countries. However, for other institutions like democracy and autocracy, the author finds that former is positively related with inequality and later is negatively related. The results shed light on the fact that transition to democracies come with higher risks for the developing countries and stable economies even with autocratic setup may have more equal societies when compared to newly adopted democratic set ups.

JEL Codes: O1, N40

Key Words: Institutions, Trade, Inequality

1. Introduction:

Many recent studies show that institutions and integration are endogenous (i.e., Rodrik et al, 2004) whereas there are issues of two way causality between inequality and institutions (i.e., see Keefer, 2002; Chong and Gradstein, 2004). Chong and Gradstein (2004) find strong evidence of bi-directional causality between institutions and inequality. Inequality may affect the quality of institutions. For example, high inequality will prevent the poor from investing in education or the ruling class may not invest in education so that the poor majority will not be politically active thus undermining the development of necessary social and political institutions. Easterly (2001) and Keefer (2002) suggests that social polarisation negatively affects institutional quality. The countries with poor institutions are also likely to have high inequality. For example in Russia in the 1990s, a small group of entrepreneurs exploited their political power to promote their own interests, subverting the emergence of institutions committed to the protection of smaller share holders and businesses. According to the Corruption Perceptions Index published by Transparency International, among the transition economies, Estonia is placed 28, and Hungary 31; whereas Russia is placed 79, and Ukraine 83. In these transition economies, weak performance of public institutions, infringement of property rights in favour of influential parties, lower willingness to use courts to resolve business disputes, lower level of tax compliance and higher levels of bribery all have been strongly correlated with inequality. Similarly, in several Latin American countries, the ruling elites, the military and large businesses impeded smaller business interests giving rise to significant informal sector. Chong and Gradstein (2004) have shown that when the political bias in favour of the rich is large, income inequality and poor institutional quality may reinforce each other, indicating endogeneity between the two.

2. Methodology

Any empirical analysis which takes trade and institutions as pure exogenous factors while analysing their effects on inequality may lead to misspecification bias. We construct our inequality model in correspondence with the reduced form growth model proposed by Rodrik et al (2004) where trade and institutions are taken as endogenous to each other as well as the dependent variable which in our case is inequality.

Our basic inequality equation would look like:

$$\text{Inequality} = f(\text{Institutions, Integration, Geography}) \dots\dots\dots (1)$$

Here in line with Rodrik et al (2004), we assume geography is a pure exogenous concept.

Much recently Kaufman et al (2002) formulated aggregate governance indicators for six dimensions of governance covering 175 countries. They relied on 194 different measures of governance drawn from 17 different sources of subjective governance data constructed by 15 different sources including international organizations, political and business risk rating agencies, think tanks and non governmental organizations. The governance indicators have been oriented so that higher values correspond to better outcomes on a scale from -2.5 to 2.5. They are categorized as rule of law (*Rl*), political stability (*Ps*), regulatory quality (*Rq*), government effectiveness (*Ge*), voice and accountability (*Va*) and control of corruption (*Ctc*). We add two more political indicators namely democracy (*Demo*) and autocracy (*Auto*) to our analysis from Polity dataset whereas, both ranging from 0 to 10.

We incorporate concepts of openness and trade policy in our regression model in order to carry out a robustness check for our results while controlling for various definitions of institutions. The ratio of nominal imports plus exports to GDP (*Lcopen*) is the conventional openness indicator (see Frankel and Romer, 1999; Alcalá and Ciccone, 2002; Rose, 2002; Dollar and Kraay, 2003; Rodrik et al, 2004). There are indicators of trade restrictiveness acting as measures of trade policy (Edwards, 1998; Greenaway et al, 2001, Rose 2002). Tariffs on intermediate inputs and capital goods (*Onti*), is considered as good proxy for trade restrictiveness and have also been employed in our study.

To capture inequality we take GINI income inequality index (*Gini*) from UNU/WIDER World Income Inequality Database (WIID).

Corresponding to equation 1, our inequality model is estimated as follows:

$$Gini_i = \alpha_1 + \beta_1 Institutions_i + \chi_1 Integration_i + \varepsilon_i \dots\dots\dots 2$$

The variable *Gini_i* is Gini Index in a country *i*, *Institutions_i* and *Integration_i* are respectively measures for institutions and general openness/trade policy and ε_i is the random error term.

As we have discussed, there are potential endogeneity problems between institutions and integration and between institutions and inequality itself. To this effect we have first regress our institutional, trade policy and openness proxies on a set of instruments. Frankel and Romer (1999) suggests that we can instrument for openness by using trade/GDP shares constructed on the basis of a gravity equation for bilateral trade flows. Hall and Jones (1999) employed distance from the equator and the extent to which the primary

languages of Western Europe are spoken as first languages today as instruments for institutions. Hall and Jones made an argument that the instruments are not correlated with the error term. Thus following Dollar and Kraay (2003) and Hall and Jones (1999), we use ‘fractions of the population speaking English (*Engfrac*) and Western European languages as the first language (*Eurfrac*)’ as an instrument for legal, economic and political institutions. As in Rodrik et al (2004), we employ ‘distance from the equator’ as another instrument (proxy for geography) also employed by Hall and Jones (1999).

$$\begin{aligned}
 \text{Institutions}_i &= \sigma_1 + \zeta_1 \text{Eng}_i + \theta_1 \text{Eur}_i + \vartheta_1 \text{FR}_i + \tau_1 \text{Disteq}_i + E_{1i} \dots\dots\dots 3 \\
 \text{Integration}_i &= \sigma_2 + \zeta_2 \text{Eng}_i + \theta_2 \text{Eur}_i + \vartheta_2 \text{FR}_i + \tau_2 \text{Disteq}_i + E_{2i} \dots\dots\dots 4
 \end{aligned}$$

Where *Eng_i* and *Eur_i* are our instruments for legal, economic and political institutions referring to fractions of population speaking English and European languages respectively. *FR_i* is instrument for openness and trade policy. *Disteq_i* is proxy for geography showing distance from the equator. At the second stage the predicted values of respective institutional, openness and trade policy variables are employed in the inequality and income share equations. The first stage results establish that the instruments are robust predictors. Higher order tests were also carried out to further establish the strength of the instruments. (The results are available on request)

3. Results

Table 1 shows the results for openness with income inequality. There is no evidence of a significant relationship between openness and within country income inequality except for two cases (columns 3 and 4). Institutions including *Rl*, *Va*, *Demo* and *Ge*, are significantly and negatively related with income inequalities. Reducing the sample to developing countries only makes insignificance of trade more pronounced. The relative significance of institutions has also declined. Another interesting observation comes forth. For a larger sample, including developed and developing countries, democracy is significantly and negatively related with the *Gini*, telling that democracies are more likely to put a downward pressure on income inequality. However when the sample is reduced for developing countries only (columns 9 and 10), the signs change in favour of autocracy. Now democracy is positively and significantly related with *Gini* and autocracy, which was insignificant for the larger sample, is significantly and negatively related with inequality. The result is simple to interpret. Democracies in developing countries are associated with higher income inequality and autocracies are associated with less income

inequality. There are several reasons why democratic experience in developing countries is related with higher income inequality and why autocracies may in fact show a negative relationship. First and foremost, there is a direct link between democracy and higher inequality because there is evidence that transition to a democracy in many developing countries have produced political instability, ethnic conflict and resultantly poor economic outcomes. (Kaplan, 2000; Zakaria, 2003; and Rodrik and Wacziarg, 2005) In literature there is also a distinction between real democracy (Populist democracy) and oligarchic society. (Acemoglu, 2003) In real democracy, the political power is more equally distributed among different social and income groups of the society and thus the poorer segments can use their political voice to implement pro poor tax system in the country. Also in a real democracy, implementation of property rights prevent barriers to entry as against oligarchic society, which may look like a democracy by holding elections but political power lies with economic elites who create monopoly positions in the domestic markets for their businesses and violate property rights. In this context, an autocratic set up, where the leaders have effectively implemented property rights and significantly improved the level playing field for all social groups to carry out good business practices, may lead to decrease in income inequality. (Glaser et al, 2004a; and 2004b)

Table 2, shows the results based on *Owti*. They are similar to the ones already discussed above for *Lcopen*. For the larger sample of developed and developing countries, decrease in tariffs rates on international inputs and capital goods bring a significant decrease in income inequality. However, as for *Lcopen*, results remain highly case sensitive. *Owti* is only significant for 2 specifications (columns 15 and 16) out of total number of 14 specifications including the ones which represent results for reduced samples (developing country only). On basis of these results we cannot claim with surety that trade is significantly related with income inequality. The results on institutions in table 2 are same as observed in table 1, which serves as further robustness check. The results suggest that for both developed and developing countries, well developed institutions whether *Rl*, *Va*, *Demo* or *Ge* mitigates income inequality but if the sample is reduced to developing countries only, we find that autocracies now represent more equal societies while democracies represent rise in inequality. The last result, as we argue, is due to the fact that most developing countries are new democracies and the transitions have been risky with negative fall outs on equality.

4. Conclusions

Well developed institutions are important for inequality mitigation. However, there is a caveat. The first assertion is only true when both developed and developing country effects are taken into account. For developing countries, the major concern is quite paradoxical regarding the relationship between institutions and inequality. Democratic set-ups in developing countries are related with rise in inequality due to transition effect. Autocracies on the other hand are capable of decreasing inequality. Greater integration with rest of the world may cause less inequality but the evidence is weak at best.

Table: 1 Gini and Openness (Lcopen)

Dependent Variables	Dependent Variable : Gini											
	(Developed + Developing)					(Developing Only)					(Developing Only) Minus Africa	
	1	2	3	4	5	6	7	8	9	10	11	12
Openness												
Nominal Trade Shares (Lcopen)	-0.49 (-0.2)	-2.11 (-0.8)	-4.71 (-1.6)*	-5.22 (-1.8)*	1.22 (0.4)	-0.59 (-0.2)	-1.08 (-0.3)	-0.10 (-0.03)	1.33 (0.37)	-1.26 (-0.3)	-0.93 (-0.2)	1.09 0.27
Institutions												
Legal												
Rule of law(RI)	-7.30 (-5.0)***					-6.44 (-1.3)						
Political												
Voice and Accountability (Va)		-5.46 (-4.0)***					1.40 (0.5)					
Democracy (Demo)			-0.71 (-1.8)*					1.35 (2.4)**			2.28 (3.2)***	
Autocracy (Auto)				0.369 (0.7)					-1.59 (-2.6)**			-2.80 (-3.5)***
Economic												
Government Effectiveness (Ge)					-8.60 (-5.0)***					7.64 (0.9)		
N	95	96	89	89	89	70	71	66	66	64	44	44
F-Statistics	13.27***	8.96***	3.14**	1.67	12.62***	0.88	0.21	2.87*	3.35	0.44	5.10*	6.10
R-Square	0.16	0.14	0.03	0.02	0.16	0.16	0.01	0.11		0.19	0.36	0.34
2SLS Bias	0.000	0.000	0.000	0.000	0.000	0.009	0.000	0.000	0.000	0.208	0.000	0.000
Sargan (p)	0.001***	0.000***	0.000***	0.000***	0.000***	0.001***	0.000***	0.011***	0.025**	0.000***	0.072*	0.187

***, **, * denotes significance at 1%, 5 % and 10% levels respectively; Standard errors corrected for as run Durbin–Wu–Hausman test (augmented regression test) for endogeneity (see Davidson and MacKinnon, 1993)

Table: 2 Gini and Trade Policy (Owti)

Independent Variables	Dependent Variable : Gini											
	(Developed + Developing)					(Developing Only)					(Developing Only) Minus Africa	
	13	14	15	16	17	18	19	20	21	22	23	24
Trade Policy												
Tariffs on intermediate inputs and capital goods (Owti)	-30.05 (-1.04)	3.73 (0.2)	56.50 (1.9)*	66.69 (2.4)*	-48.34 (-1.1)	-25.02 (-1.1)	-18.61 (-1.10)	-9.18 (-0.5)	-12.46 (-0.7)	-32.26 (-1.1)	3.38 (0.1)	-0.69 (-0.03)
Institutions												
Legal												
Rule of law(Rl)	-0.45 (-3.5)***					-7.13 (-1.3)						
Political												
Voice and Accountability (Va)		-5.80 (-2.0)**					2.61 (0.80)					
Democracy (Demo)			0.33 (0.4)					1.31 (2.2)**			2.34 (2.5)**	
Autocracy (Auto)				-1.13 (-0.9)					-1.68 (-2.5)**			-3.01 (-2.8)***
Economic												
Government Effectiveness (Ge)					-13.23 (-2.8)***					-4.01 (-0.58)		
N	70	71	68	51	68	53	54	51	51	51	34	34
F-Statistics	17.07***	11.80***	3.57**	2.79*	13.57***	0.98	1.22	2.79*	3.26**	0.64	3.16**	3.88**
R-Square	0.18	0.18	0.59	0.15	0.48	0.45	0.11	0.15	0.22	0.40	0.06	0.52
2SLS Bias	0.073	0.124	0.155	0.027	0.166	0.041	0.001	0.027	0.019	0.144	0.181	0.123
Sargan (p)	0.036**	0.000***	0.002**	0.037**	0.028**	0.027**	0.005***	0.038**	0.092*	0.009***	0.185	0.336

***, **, * denotes significance at 1%, 5 % and 10% levels respectively; Standard errors corrected for as run Durbin–Wu–Hausman test (augmented regression test) for endogeneity (see Davidson and MacKinnon. 1993)

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DATA AND SOURCES:

Auto: Autocracy, Year: 1999, Source: Polity IV dataset

Ctc: Control for Corruption, Year: 1997/98. Source: Kaufman et al (2002)

Disteq: Distance from Equator of capital city measured as $\text{abs}(\text{Latitude})/90$. Source: Rodrik, Subramanian & Trebbi (2002)

Engfrac: Fraction of the population speaking English. Source: Rodrik, Subramanian & Trebbi (2002)

Eurfrac: Fraction of the population speaking one of the major languages of Western Europe: English, French, German, Portuguese, or Spanish. Source: Rodrik, Subramanian & Trebbi (2002)

Ge: Government Effectiveness, Year: 1997/98. Source: Kaufman et al (2002)

Lcopen: Natural logarithm of openness. Openness is given by the ratio of (nomnal) imports plus exports to GDP (in nominal US dollars), Year: 1985. Source: Penn World Tables, Mark 6.

Logfrankrom (FR) : Natural logarithm of predicted trade shares computed following Frankel and Romer (1999) from a bilateral trade equation with 'pure geography' variables. Source: Frankel and Romer (1999).

Owti: Tariffs on Intermediate and Capital Goods, 1985. Source: Rose (2002)

Ps: Political Stability, Year: 1997/98. Source: Kaufman et al (2002)

Rl: Rule of Law, Year: 1997/98. Source: Kaufman et al (2002)

Rq : Regulatory Quality, Year: 1997/98. Source: Kaufman et al (2002)

Va: Voice and Accountability, Year: 1997