

## **Institutional Quality and Economic Growth: A Systematic Literature Review**

**Kashif Abbas Shah**

MS Scholar department Business and Finance University of Central Punjab Lahore  
[at-kashifabbas@gmail.com](mailto:at-kashifabbas@gmail.com)

**Sadia Yasmeen**

MS Scholar department Business and Finance University of Central Punjab Lahore  
[at-sadiayasmeen@gmail.com](mailto:at-sadiayasmeen@gmail.com)

**Hajra Rasool**

MS Scholar department Business and Finance University of Central Punjab Lahore  
[at-hajrarasool@gmail.com](mailto:at-hajrarasool@gmail.com)

### **Abstract**

The objective of this study is to establish a correlation between the phenomenon of economic growth in Pakistan and the concept of total factor productivity. The region has had a significant challenge in terms of its economic growth, which has been characterized by a sluggish pace in recent times. This study conducts a comprehensive analysis of the existing literature pertaining to the factors that influence economic growth in Pakistan. The findings of this research indicate that the primary concern lies in the sluggish progress of total factor productivity (TFP) improvement. Moreover, a correlation exists between this matter and the caliber of institutions inside the vicinity. Unfortunately, articulating the essence of institutional excellence in a substantive manner poses considerable challenges. This has an impact on public policies pertaining to the advancement of regional economic growth. Ultimately, it has been substantiated that although the aforementioned matter holds significance for Pakistan, the area does not possess any distinctive characteristics in relation to this phenomenon.

**Keywords:** Institutional Quality, Economic Growth.

## Introduction

Over the past fifty years, the economies of Latin America have faced three interrelated challenges. The most significant problem was that the region personified macroeconomic instability. Inflation, erratic GDP growth, and high unemployment were all but normal economic conditions. Second, of all the regions of the world, Latin America has seen the highest level of economic disparity for as long as reliable statistics have been available.<sup>1</sup> The economy's extremely slow growth speed has been the final and most significant problem. By international standards, the GDP per capita growth of Latin America has not kept up with that of the more fortunate emerging countries. Over the past 20 years, a significant amount of research has been conducted on this topic. In summary, Latin America's economic growth has lagged due to a slow increase in total factor productivity (TFP). It's noteworthy to note that

throughout the same time frame, TFP elements have become more and more central to studies on economic growth as a whole. The study's main conclusion is that institutional quality affects TFP, which in turn affects GDP growth rate in a country.

This research seeks to establish a link between this broad realization and the problem of Latin America's sluggish economic development. The next part goes into more depth on the importance of the region's recent modest economic development. A review of the literature on the variables impacting economic growth in Latin America indicates that TFP seems to be the primary concern and that it is linked to the quality of the institutions in the area. The difficulty of providing a coherent definition of institutional excellence is illustrated in the next section. The final section discusses how this affects public policies connected to regional economic

growth. Finally, we show that although the issue underlined may be especially important for Latin America, the continent is not exceptional in this regard.

## **Latin America's Economic Growth**

The primary economic issue facing Latin America is that the region's GDP per person is barely 20% of the US average. It hasn't always been like this. As recently as 1700, the GDP per capita of Latin America was nearly equal to that of North America. The conventional historical perspective held that between 1820 and 1870, Latin America lagged behind. The protracted unrest that ensued after the independence wars caused nearly fifty years of sluggish economic progress. A significant amount of the wealth disparity between North and South America may be attributed to the region's delayed independence and political unrest.

The ensuing "Golden Age," also known as the belle époque, was a protracted stretch of time from 1870 to the Great Depression during which the economy expanded rapidly. The tale is more intricate when it comes to the years 1940–1980.

The region's GDP per person increased, albeit not very quickly. This outcome is connected to the previously indicated percentage difference. The GDP per capita difference between the industrialized countries and the area hardly changed over this time. During the 1980s, known as the "Lost Decade," Latin America slipped farther behind, and much of the past 20 years have been devoted to catching up.

When compared to global averages, Latin America's GDP per capita seems rather high. In 2008, the GDP per person in the area was \$7,785. The GDP per person in this country is more than double that of the typical middle-income country. However, this must be

compared to high-income countries' GDP per capita of \$40,525. Considering the region's slow economic growth since the mid-1900s, it's interesting to speculate about what GDP per capita would have been achieved at a quicker pace. Latin America's success is sometimes likened to East Asia's miraculous economies.

Perhaps this example is not as relevant as it first seems. That a normal Latin American country will ever look like Hong Kong is quite unlikely. A similar situation emerges when high-income countries in the twenty-first century are compared to Latin America. However, even accounting for these differences, Latin America's economic performance has been inadequate. In 1955, the GDP per capita of Latin America was 43% of that of high-income countries. By 2000, the average for the area was less than 25 percent.

A similar picture emerges when examining economic development in

Chile, the best-performing nation in the area. Chile's economic growth has been much faster than the region's average since the 1970s. Chile has a GDP per person of more than \$10,000 as a result. A recent study compares the economic development of Latin America to that of Indonesia, a more relevant country. The country of Indonesia in Southeast Asia has many characteristics with much of Latin America. However, Chile's economic progress has fallen well short of Indonesia's. The connection with Latin America is especially relevant as Indonesia is a major commodity exporter and has experienced political instability similar to that region.

## **Qualitative Research on the Development of Latin America**

As stated previously, formal econometric research on economic expansion in Latin America is scarce. This section provides an analysis of the more widely recognized studies, focusing on their treatment of TFP

specifically and the overall results. This collection of works is linked to the "new institutional economics," an academic discipline that emphasizes the role of institutions in economic growth.

The occurrence of the customary delay occurred upon the integration of these concepts into an empirical framework. Significantly more time was required to implement the fundamental principle in Latin America. This collection of work bears the lineage of de Gregorio's (1992) and Taylor's (1998) papers. Recent research has focused on examining the influence of institutional variables on the sluggish expansion of TFP. A considerable proportion of the variables presently utilized to quantify institutional characteristics of economies are relatively new, which enhances their originality. A concise summary of the literature's findings is provided below.

A pioneering endeavor to incorporate institutional factors into a conventional

model of development for Latin America was initiated by Chong and Zanforlin (2004). Their article is noteworthy for being the initial in a sequence of endeavors to quantify the effects of these parameters on growth; however, they did not evaluate the consequences of these variables on TFP. Although two sources are employed to quantify institutional quality, subsequent research has solely utilized the data from the International Country Risk Guide (ICGR). This study assessed institutional quality using an average of five ICGR variables: risk of expropriation, government repudiation of contracts, law and order tradition, government corruption, and bureaucracy quality. The significance of the paper's findings lies in the correlation that is established between enhanced institutional quality and accelerated regional economic expansion. An inherent limitation of the study arises from the specification,

which precludes the quantification of the impact of institutional quality on TFP. This remains an essential concern that has not been attended to. Is a more direct assessment of the relationship between institutional quality and TFP attempted, or is it sufficient to incorporate an institutional variable or variables into a normal development model? As we shall see, opinions continue to be divided on this matter. Chong and Zanflorin (2004) and de Gregorio and Lee (2004) have also arrived at comparable results. Although institutional factors are included in the regressions, their explicit effects on TPF are not accounted for in the models. Government consumption, the rule of law, the inflation rate, democracy, and transparency were utilized as surrogates for the institutional components in this particular case. While the impact of these variables on TFP is not examined in this study, it seems that they all contribute to the anticipated effects on

economic growth. This essay argues for an additional compromise. Numerous metrics and institutional factors pertaining to the rule of law are relatively recent. It is evident that a number of additional metrics, such as inflation and openness, can be calculated over considerably extended durations of time. A trade-off between data availability and measurement quality may result from this. The scholarly articles appear to be divided regarding the most effective approach to this matter.

2005's Fernandez-Arias et al. study was the first empirical investigation to explicitly investigate the relationship between TFP and institutional quality. They ascertained that TFP is accountable for the region's lethargic development, a conclusion that is now generally accepted. Their subsequent efforts to identify the variables influencing the development of TFP constitute the differentiation. As

described in the previous study, the impact of education, life expectancy, openness, imports of machinery and equipment, credit to the private sector, government consumption, inflation, the Black-Market Premium, and the ICRG variable on TFP was investigated.

The findings revealed that the ICRG, Openness, and Inflation appeared to have the most significant correlation with TFP. Despite the fact that all of these factors appear to "function," it is uncertain why they operate or how they may interact. As usual, these findings are insightful and suggestive; however, they also present numerous unresolved issues.

Cole et al. (2005) reaches comparable conclusions regarding the relatively modest expansion of Latin America. Their persuasive empirical research concludes that the region's sluggish development is almost exclusively attributable to TFP's sluggish growth. Following this, they assert that sluggish

human capital development is not the issue. Their primary objective is to provide clarification on matters pertaining to TFP. However, they take a significantly different approach to problem explanation than their predecessors. They argue that barriers to entry, underdeveloped financial markets, labor regulations, and impediments to internal competition, including tariffs, have impeded innovation. Consequently, the output of the region's nations has declined. Despite having a solid intuitive rationale and being substantiated by case-type examples, experimental application of this approach proves to be difficult.

The article by Chumacero and Fuentes (2006) validates the importance of TFP as a mediator of the inadequate development performance observed in Latin America.

However, the research does not examine the possible factors contributing to the region's inadequate total foliar

production (TFP) expansion. Instead, its main emphasis is on detecting flaws in the empirical relationships. Greir (2007) provides a valuable critique of the study by Cole et al. This investigation estimates the development equations for the period spanning from 1955 to 1995 in Latin America. The results validate the notion that low TFP causes diminished growth. Following this, the author compares the projections for a sample of affluent nations with those for Latin America. The provided empirical findings are intended to provide insight into this inconsistency rather than quantifying their direct influence on TFP.<sup>8</sup>

In the subsequent sections, the article attempts to elucidate this disparity through the lens of demographic diversity, government expenditure, government type, learning-by-exporting, technological diffusion, capital openness, and educational quality. Additionally, political and

macroeconomic instability are considered. Additional dummy variables were included to represent landlocked, debt crisis, climate change, and hydrocarbons. The findings indicate that government expenditure, diversity, and government type all contribute to a decline in TFP. Moreover, landlocked proxy factors, the oil crisis, and the debt crisis were crucial. Additional estimates in the paper indicate that exports of manufactured products may stimulate expansion.

The reader may have identified a puzzling aspect within this body of literature. In respect to the correlation between alterations in technology and human capital and fluctuations in TFP, it seems that the aforementioned studies fail to fulfill this anticipation. Before exploring the ramifications of institutional quality, none of these studies attempt to account for the impact of human capital accumulation or R&D on TFP.<sup>9</sup>



Despite the lamentable nature of this omission, it may still be rational. In addition, standardization is lacking in the corpus of research pertaining to this subject. Nevertheless, the aforementioned results ought to be approached with prudence.

This also pertains to the corpus of research concerning the impact of institutions on development.

This is an ongoing endeavor.

With these disclaimers in consideration, the condensed review of the literature should have highlighted two aspects. Initially, it is now abundantly clear that the sluggish or negative growth of TFP has been the primary cause of Latin America's dismal economic performance over the past few decades. At this time, there exists a sufficient body of empirical research to support the conclusion that this is the case, notwithstanding the inability of a single study to definitively establish this. Despite the increasing volume of

knowledge that hinders the ability to definitively deem TFP problem-free at this moment, it seems implausible. If so, it would be extremely important to account for variations in the region's TFP. Thus, we arrive at the second issue. Clearly, there is no genuine consensus regarding the variables that affect TFP. It has been noted that several studies have attempted to explain institutional quality using ICGR data as a substitute. Institutional quality is occasionally substituted with government expenditure, inflation, or transparency, as stated in alternative publications. Further elucidations extending beyond the aspect of institutional quality can be found in additional articles. Proxies for variables such as weather, political risk, and educational standard are a few examples. At this juncture, the proliferation of "explanations" is beginning to become somewhat disorganized and improvised. Although

this may appear crucial, it is not in fact so. After determining that TFP productivity is a concern, numerous other variables (including the number of sunny days) may exert an influence on TFP. These two subjects are discussed in the following section of the paper.

## **Institutional Quality and TFP**

This section provides a concise empirical exercise to demonstrate a few of the difficulties that might be encountered when attempting to establish a correlation between growth and institutional quality. A simple regression example is utilized to achieve this objective. Comparatively frequently discussed in the academic literature, the independent variable is the TFP disparity between Latin America and East Asia. One notable characteristic of this dataset is the incorporation of data pertaining to this discrepancy for every country situated in the region. When the disparity is determined by deducting the TFP for

Latin America from the TFP for East Asia, it exhibits a negative value for every country within the region. Chile exhibits a minimum discrepancy of -0.3, whereas Venezuela demonstrates a maximum disparity of -2.0. This discrepancy is subsequently regressed against three standardized institutional quality indicators for each nation. The global rankings of nations are constructed using the data provided by Doing Business. The scores for Regulatory Quality and Rule of Law were extracted from the Governance Matters data. The Doing Business rank should be denoted by a negative sign to indicate that as the rank increases, the aforementioned divide becomes narrower. Positive coefficients should be assigned to the remaining two metrics. The present relationship has been purposefully crafted to possess an entirely suggestive quality. This observation simply indicates that the

process of selecting prestigious institutions may be difficult.

Table 1 Relationships between TPF and Measures of Institutional Quality

| Measure            | Coefficient | Significance |
|--------------------|-------------|--------------|
| Doing Business     | -0.989      | 0.312        |
| Rule of Law        | 0.576       | 0.129        |
| Regulatory Quality | 0.789       | 0.901        |

The data stated above show that all institutional quality measures are accurate in their signals. That's a really good start. However, there are significant differences in the coefficients' amounts. Every coefficient also has no statistical significance. The rule of law seems to be the most successful in this little experiment. At most, it is rather substantial. One simple case when the rule of law "wins" Is this something that happens often? All of the

significance levels are almost the same, and they all have the right indication.

A slightly different set of data may have easily produced a different result. To give an illustration was the aim of the activity. It is possible for different institutional quality indices to yield contradictory empirical results when it comes to Latin America. Just three of the more often used measurements are shown in the example above. There are several more that are easily available.

### Conclusion

The objective of this study was to spark discussion about the relationship between institutional quality and economic growth in Latin America. The fundamental issue with regional economic growth is that the region's TFP growth rate is low. The relatively recent but limited research on growth in the region virtually consistently confirms this. There also appears to be widespread agreement that low TFP growth is primarily caused by

inadequate institutional quality. Understandably, the focus of contemporary empirical study in the field is on this link. However, there are a variety of alternative metrics of institutional quality. On a logical level, it is unclear which of these variables should be employed for empirical research. An index number formed from the various indexes is one proposed approach.<sup>12</sup> While this eliminates certain unpleasant decisions, an index still leaves the issue of weights.

In the meanwhile, researchers in this field may need to be more specific about the measure of institutional quality they use. It is possible that such decisions are not trivial. Some variables may function well while others may fail for unknown reasons. Simply recognizing plausible options may be beneficial. When there are options and no clear selection criteria, using what works is not always the best option. What should be avoided at this stage is the usage of a certain

variable only because others have done so. The literature appears to be far too undeveloped for such strategy.

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