



DOES RULE OF LAW AFFECT ECONOMIC GROWTH POSITIVELY?

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ABSTRACT

Efficient institutional structure resolves the uncertainties in the market and the problem of asymmetric information, and thus creates a positive erogeneity, ensures the efficient distribution of the resources and makes a positive impact on the functioning of the economy. In addition to this, especially rule of law forms the basis of the socio-economic development. In the presence of the factors such as prevention of corruption and freedom of expression, institutional structure has a significant impact on economic growth. However, there are empirical studies that state that institutional efficiency boosts economic growth in developed countries, whereas it doesn't have an impact or has a negative impact on economic growth in developing countries. For all these reasons, the impact of institutional efficiency on economic growth in developed, developing and underdeveloped countries will be analyzed in this study. In this study, the effect of institutional effectiveness on economic growth has been analyzed in both three country groups from 2002 to 2015 by using GMM. Dependent variable is GDP and the independent variables are institutional variables (rule of law, fight against corruption, voice and accountability). Based on our primitive findings we expect that developed institutions effect economic growth positively in develop countries unlike developing countries.

Keywords: *institutions, institutional effectiveness, rule of law, economic growth, GMM*

Introduction

North (1990) defines institutions as: “*Institutions are the rules of the game in society or, more formally, are the humanly devised constraints that human interaction.*” In determining the rules mentioned in the definition, it is expressed that one of the most effective tools is law. The relationship between institutional structure and economy is also one of the points to be considered. Institutional structure eliminates the market distortions caused by imperfect data. Therefore, ensuring efficient decision-making of individuals and institutions by eliminating distortions is one of the significant impacts of institutional structure on economy. Institutional structure ensures that economic transactions between economic units are done in a cheaper and safer way. By this means, efficient institutional structure that increases efficiency and quality, also contributes to the development of industry and the revival of trade. Also, it may be claimed that it prevents waste of resources with the effect of reducing the inefficient use of resources by the combination of institutional stability and economical and political stability. Institutional structure contributes to economic growth by providing use of resources in productive and efficient areas (Yapraklı, 2008: 301-317). Besides, prevention of corruption, transparency and accountability are also significant for the institutional structure to function effectively and efficiently. Rule of law principle, which is the cornerstone of rule of law and democracy, is the greatest assurance needed by people both individually and as a society. Factors like limiting the power of the state by law and protecting the individual rights and freedoms, ensuring an equal and fair environment, accepting the superiority of law over any individual create rule of law principle. Although there is not a universal consensus on the concept of “rule of law”, the main principles of rule of law are defined by the Secretariat General for UN. In the 2004 report of the secretariat, it is considered within the scope of rule of law that all individuals and institutions including government agencies may be accessible and they may be held accountable under the laws consistent with the international legal norms and principles (Telli, 2014:314). It is also emphasized in the UN report that the term “rule of law” involves these principles: equality before the law, accountability to the law, fairness in the application of the law, separation of powers, participation in decision-making process, legal certainty, avoidance of arbitrariness, and procedural and legal transparency.

Law is specific and compelling by its nature (Hafizoğulları, 2002:19). It may cause an individual to be deprived of various rights and benefits. However, it also protects an individual's rights and freedoms or economic rights and benefits from unlawful acts (Kelsen, 1951:706). Economy is the main factor which may affect the community, starting from the individuals, and even the state positively/negatively. The presence of the close relation between law and economy keeps the state standing both nationally and internationally. In this respect, the biggest danger that the state may face is the economic uncertainty. A state in such an uncertainty cannot guarantee the economic activity with laws and regulations, cannot determine the legal framework or may face a variety of strategies that may set the development of the country back (Karabacak, 2003:67). Therefore, establishing the necessary legal framework is of great significance for the development of global markets. In addition, it proves the relation between economy and law clearly that UN accepts the underlying principle of acts concerning human rights as rule of law, and that World Bank sees it as a necessary precondition of economic and social progress (Karabacak, 2003:63).

Considering rule of law with other principles like justice, equality, transparency, accountability give more accurate results in terms of implementation since these principles are not independent or irrelevant from each other. It is compulsory that the institutions meet the needs, be transparent and act in accordance with rule of law principle for a fair and equal way of behavior. Accountability is the principle whose absolute presence is needed for ensuring and sustaining rule of law principle. Fight against corruption which affects both developing and developed countries is more controllable and effective when rule of law is as it should be (Karabacak, 2003:75). Considering all these reasons, in this article, the relationship between rule of law, fight against corruption, voice and accountability and the economic growth. At this stage, countries are divided into 3 groups according to their level of development. It may be possible to identify if the relationship between the specified variables change according to the institutional development through comparison between groups. Due to the reasons mentioned above, the relationship between dimensions of governance and economic growth has been analyzed in this study. The models have been estimated using yearly data from 2002 to 2015 for country groups. Gross Domestic Product per capita has been considered as the dependent variable. The independent variables are rule

of law index, control of corruption and voice and accountability. By using the variables above, relationship between the series has been analyzed with Generalized Method of Moments.

Relationship between Dimensions of Governance and Economic Growth

It is accepted in almost all relevant studies that the relationship between economy, institutional structure and rule of law has a serious place in every stage of life of individuals and the state and that this relationship is an indivisible whole. Recently, the growing population of the world indicates that the balance between the economy and law is increasingly sensitive since the level of economy affects the political state of the country seriously, and it even surpasses politics and plays a key determinant role. Since the countries with rich resources and regular economic policies are not dependent on outside financial resources, they are also comfortable in terms of human rights. It is indispensable that developing countries in the circle of poverty and with limited resources are dependent on outside financial resources, and thus are exposed to strict economic programs. Public opposition emerging in time sometimes ignores the law and prepares the ground for negative enforcements (Çeçen, 1989:526). Especially in such cases, it can clearly be seen that there is a very close relationship between economy and rule of law.

In communities in which the law is superior and which is in safety and peace, since the economic rights are guaranteed, development and growth gains momentum. Nationally, processes such as protection of property rights or creation of capital markets are factors affecting the economic development, and also creation of a favorable environment for foreign investors is necessary for creating an economic growth in the legal platform. Similarly, freedom of expression, accountability and prevention of corruption are also significant variables for economic growth to take place and to be sustainable. These components of institutional structure affect economy in several different ways. Firstly, increase in prosperity raises the demand of higher quality institutions (transparency and accountability). Secondly, high increase in prosperity makes the institutions more affordable. Lastly, economic development is new agency of change and creates the demand of new institutions (Chang, 2010:476). Acemoğlu, Johnson and Robinson (2005), relates the effect of institutional structure on economy with 3 institutional characteristics; economic institutions, political power and political institutions.

There are several studies on the relationship between institutional structure and its characteristics and economy. These studies change according to the income status, institutional structure and economical performance of the countries. In the study that Kaufmann, Kraay and Zoido-Lobaton (1999) did for 150 countries, they found out that there is a serious cause and effect relationship between rule of law and income per capita, literacy and infant mortality rate. And income per capita gap may be 3 times more in the countries not implementing rule of law principle compared to the countries implementing it.

Nobel-winning economist North (1990), who believes that short-term economic growth is possible without the requirement of the rule of law, argues that to provide long-term economic growth especially in dictatorial regimes, development in rule of law issues is required since North and Thomas (1973) states that lack of protection of property rights prevents capital investments which would help economic growth. Furthermore, Knack and Keefer (1995: 207-227) and Hall and Jones (1999: 83-116) claim that there is a close and positive relationship between property rights and economic growth. Protecting property rights and taking them under the state guarantee and thus the increase in investment demand affect the economic growth positively as it is in technological and other various innovations. Knack thinks that it is possible to prevent macroeconomic instabilities this way (1999:185-211). In their study covering the years 1950-2009, Valeriani and Peluso (2011) made a panel data analysis for 181 developed and developing countries. As a result of the analysis, they stated that institutional quality has a positive effect on economic growth in developed and developing countries. Thus, generally, it can be concluded that with the increase of rule of law in a country, social welfare and per capita income increases seriously in that country. However, there are studies stating that the positive effect of institutional structure on economic growth is only possible in developed countries. In this respect, Yapraklı (2008), in his panel data study for 36 middle income countries, found a negative relationship between components of institutional structure and economic growth. Londregan and Poole (1990), in their study for 121 countries between the years 1950-1982, used the variables population, income per capita, riots, failed coups, successful coups, elections, political executions and deaths due to domestic political violence and couldn't find a direct relationship between income and the stated variables. Bienen et al. (1993),

Sachs and Warner (1997), in their study for African countries, stated that the slow growth in Africa is caused by natural causes such as limited access to the sea, abundance of natural resources, and tropical climate. Besides, in the study, they concluded that basic economical policies like being open to international trade, government saving and market-supporting institutions have a significant effect on economic growth. Helliwell (1992) studied the relationship between democracy and economic growth in his study for 125 countries. In the study, he concluded that there is a positive relationship between democracy and economic growth countries in high income countries, yet he claims that democracy has a negative but insignificant effect on growth in countries in low income countries. Doucouliagos and Ulubaşoğlu (2008), in their study on 84 countries, concluded that there is not a relationship between democracy and economic growth. As a result of the study for 145 countries grouped as high income, middle income and low income. Fabro and Aixala (2009) found that institutional quality stimulates economic growth only in high income and middle income countries. Ata, Koç and Akça (2012), in their study on 30 OECD countries, found a positive and statistically meaningful results about the relationship between accountability and rule of law and economic growth whereas they couldn't find a direct relationship between regulatory quality, prevention of corruption and economic growth. However, in the studies of Alesina and Perotti (1994); Alesina and Rodrik (1994); Alesina et al. (1996); Chong and Calderon (2000) and Chang (2003), results show that institutional structure is not as effective as it is in developed countries and that institutions have a negative effect on growth. In Table 2, there are some of the studies on the relationship between institutional structure and economic growth.

Data and Methodology

As regards to the data employed in this study, the annual data is collected for the period 2002-2015 for the country groups. Country groups are classified according to World Justice Project report in 2015. Each country group includes 20 countries.

The variables used in this study covers real gross domestic product per capita (GDP) in billions of constant 2005 US \$, rule of law index, control of corruption index and voice and accountability index. The data of real (GDP) per capita is sourced from World Development Indicators 2015 (World Bank), and rule of

law index, control of corruption index and voice and accountability index is sourced from The Worldwide Governance Indicators 2015. All variables are in natural logarithms. Analysis will be estimated by using Generalized Method of Moments (GMM). OLS estimator and GLS estimator may give biased results in estimating dynamic panel data sets. For this reason, Arellano and Bond (1991) developed Generalized Method of Moments model which is a more effective method. In this method, first order differences of dynamic panel data analysis variables are taken, and past values for dependent variables are used as instrumental variable (Baltagi, 2001:130-131). The model developed by Arellano and Bond (1981) is defined as One-step and Two-step. In One-step model, error term doesn't have a serial correlation and has a homoscedastic characteristic. Explanatory variables are uncorrelated with the effect particular to groups in unobservable panel.

Conclusion

According to the view arguing that economics depends on institutions not on individuals, efficient institutional structure solves the problem of market uncertainties and asymmetric information, creates positive exogeneity, and provides an efficient distribution of the resources. Institutional structure involves significant factors such as rule of law, control of corruption, freedom of expression, political stability, quality of bureaucracy and guaranteeing property rights. These factors increase reliability of economy especially in developed countries and attract investments, and increase economic growth. Besides this, institutional factors are substantially effective in eliminating the unfair distribution of income. However, there are empirical studies claiming that institutional efficiency increases economic growth in developed countries, and has no effect or negative effect in developing countries. Therefore, it can be stated that institutional efficiency is not a reason of growth but a result of it.

Considering these reasons, in this study, the effect of institutional efficiency on economic growth in developed, developing and under-developed countries is analyzed. With the data obtained from the countries classified according to their development levels, the relationship between institutional structure and economic growth is clearly revealed.

In this paper, the relationship between dimensions of governance and economic growth for 2002-2015 in high income, middle income and low

income countries has been investigated. The empirical results show that rule of law index, control of corruption index and voice and accountability index are positively correlated with GDP in high income countries. On the other hand, as a result of the studies on developing and under-developed countries, the results are not statistically meaningful. The results obtained in this study coincide with the results obtained by Fabro and Aixalá (2009); Valeriani and Peluso (2011), Londregan and Poole (1990); Bienen et al. (1993); Sachs and Warner (1997). Fabro and Aixalá (2009) have found evidence that institutional quality variable is not sufficient for level of poor countries. Besides, institutional quality has quite a significant effect on high income countries. While institutional quality has a positive effect on economic growth, it shows different size of effect on developed and developing countries in the results of Valeriani and Peluso (2011). Londregan and Poole (1990); Bienen et al. (1993) and; Sachs and Warner (1997) also have found evidence that supports our result.

In this study, it tries to respond to questions about whether or not the positive relationship between rule of law and economic growth in terms of high income, middle income and low income countries. The evidence suggests that this relation is not relevant to explain the level of economic development of the middle income and low income countries. In the light of the data obtained from the analysis, it can be stated that the efficiency of institutional structure is not a reason but a result of growth.

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