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Institutions and economic development in Brazil

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Abstract

This paper investigates the effects of institutional reforms in Brazil. It first provides a comparative assessment of the level of institutional development of Brazil with other Latin American countries such as Chile and Argentina. It considers institutional indicators on "*doing private business*", including those related to the start up costs, employment rigidity, the expropriation of private investment and bankruptcy law. In general, Brazil presents a lower level of institutional development than Chile and Argentina. As an example, the number of procedures to start a business in Brazil is roughly twice as large as in Chile. We evaluate the importance of institutional differences on economic development using data for a wide cross-section of countries. As in Acemoglu, Johnson, and Robinson [Acemoglu, D., Johnson, S., & Robinson, J. A. (2001). The colonial origins of comparative development: An empirical investigation. *American Economic Review*, *91*(5), 1369–1398], we use the European mortality rate in the colonial period and the "legal origin" to exploit exogenous variation in the level of institutions. We identify issues where institutional reforms are likely to significantly affect per capita gross domestic product (GDP), the ratio of private credit to GDP and the ratio of investment to GDP. We then construct three indices developed in Tavares [Tavares, J. (2004). Institutions and economic growth in Portugal: a quantitative exploration. *Portuguese Economic Journal*, *3*, 49–79] that measure the potential of institutional reforms by using institutional distance, in our case between Brazil and Chile. The most promising reforms for the Brazilian economy, as far as their effects on output per capita, are, in decreasing order: (i) reducing the number of procedures to open a business; (ii) decreasing the average time involved in insolvency proceedings; (iii) increasing labor market flexibility; and (iv) increase effective creditor's protection.
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1. Introduction

Theoretical and empirical studies have shown that institutions have a first order effect on per capita income and on economic development (see Hall and Jones (1999)).[1] Such studies have corroborated the Douglass North (1990) hypothesis that institutions are the underlying determinant of long-run economic performance of nations. Countries with better institutions not only invest more in physical and human capital, but they also use these factors more efficiently.

In economics we cannot use laboratory experiments to determine the impacts of different policies and institutions on economic development. However, in the real world, there are various historical incidents that come close to the concept of "natural experiment". Some examples, as pointed out by Mancur Olson (1996), are the divergent path of North and South Korea, East and West Germany, and Hong Kong and Mainland China, countries that were divided for political reasons and followed divergent economical paths.[2] Another "experiment" is the colonization of the new world by Europeans. As argued by Acemoglu, Johnson, and Robinson (2001), Europeans adopted very different colonization policies in different colonies, originating a very diverse set of institutions.[3] Where settler mortality was low and long stays palatable, colonizers adopted institutions that provide a legal environment that protected private property and constrained government and elite expropriation of private investment. In contrast, where settler mortality was high, colonizers created an extractive state, whose main purpose was the transfer of as much of the resource base as possible to the colonizers. Since there is path dependence on institutional changes, past institutions are correlated to current institutions and therefore affect current economic performance.

This does not mean that there is "*fate factor*" in economic development and poor countries will necessarily remain poor in the future. There is mobility in development and history is full of place changes in the economic development ladder. Some countries which were poor 40 years ago became rich in one generation (e.g., the so-called economic miracles of Singapore, South Korea and Taiwan). Others, which were relative rich 40 years ago, such as Argentina and Venezuela, have lost their position in the economic ladder and became economic disasters.[4] Finally, some countries have had persistent improvements in development despite being located in stagnated regions, e.g., Botswana and Chile.

[1] Cavalcanti and Novo (2005) also find evidence that institutions contribute significantly to more output per worker. In addition, they show that (i) the marginal contributions of institutions are larger at the bottom quantiles of the (conditional) distribution of output per worker, i.e., poor countries benefit the most from better institutions, and (ii) the conditional distribution of output per worker tends to become less disperse as countries reach higher levels of institutional development. Therefore, institutions are fundamental not only in promoting more development (output per worker) but also in promoting convergence in output per worker across nations.

[2] As an example, North Korea stagnated in the last 40 years while South Korea is one of the growth miracles.

[3] Differently from North, Summerhill, and Weingast (2000), Sokoloff and Engerman (2000, p. 219) point out out that "*the relationship between national heritage and economic performance is weaker than popularly thought*... *Having been part of the British Empire was far from a guarantee of economic growth.*" They instead emphasize the role of factor endowment. According to them, the colonies that specialized in the production of sugar and other highly valued crops associated with large slave plantations adopted institutions that protected the elites and restricted the development of the low classes. The distribution of wealth remained highly unequal over time due to institutions that restricted the right to vote and the low investment in public education.

[4] According to the Penn World Table 6.1 in 1960 output per worker in Argentina and South Korea were about 60 and 15% of the United States output per worker, respectively. Forty years later output per worker in Argentina and South Korea were roughly 40 and 60% of the output per worker in the United States, respectively. In 1960 output per worker in Venezuela was about 85% of the American output level and the figure dropped to less than 30% in 2000.

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