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ABSTRACT

Faced with institutional competition, accelerated by the process of globalization, countries have basically two options: participate in it and get their benefits or isolate themselves and be left aside. With a few exceptions, Latin American countries have not been able to cope with competition and are lagging behind. In this article an attempt will be made to evaluate the quality of Latin American institutions in terms of macroeconomic stability and the rule of law through the building of a composite index called "Institutional Quality Index", averaging together indexes evaluating economic and political issues, trying to capture the essence of institutional arrangements that have allowed countries to progress and showing whether Latin America's institutions are able to compete in the world arena.

It will be concluded that small countries, such as Chile and some islands on the Caribbean and Central America, get better qualifications than larger countries in the region. This may be explained by the fact that their size forces them to be open economies where contracts and property rights are enforced, since their economies would not be self-sustainable if closed.

Also, the "heritage" of legal systems such as the British "common law" shows that some countries could get a better performance of justice as shown by, for example, the high qualifications of some Caribbean countries as compared to others in Latin America that inherited the legal systems of Spain or Portugal. A few recommendations follow.

THE QUALITY OF LATIN AMERICAN INSTITUTIONS

> Where possession has no stability, there must be perpetual war. Where property is not transferred by consent, there can be no commerce. Where promises are not observed, there can be no leagues nor alliances[1]
>
> David Hume (1711–1776)

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What we call now "globalization" is a process of increased mobility of resources, thanks to technology and the removal of regulatory barriers. The increased mobility brings with it a more intense competition among jurisdictions. Resources, mainly through "exit" mechanisms, move around, although imperfectly, looking for the best places to set up shop.

With a few exceptions, Latin American countries have not been able to cope with competition and are lagging behind. It will be argued here that even though natural resources and the size of markets are important determinants of investments, what will be called "institutional quality" matters most.

Latin American countries have also been affected by macroeconomic instability. It is a region where instead of the "rule of law", the "rule of men" prevails, particularly populist "caudillos" of the left and right.

In this article I will try to evaluate Latin America in terms of macroeconomic stability and the rule of law through the building of a composite index called "Institutional Quality Index", averaging together indexes evaluating economic and political issues, trying to capture the essence of institutional arrangements that have allowed countries to progress and showing whether Latin America's institutions are able to compete in the world arena.

INSTITUTIONAL COMPETITION

Competition in the marketplace is a dynamic process that allows consumer preferences to be revealed and producers attempt to satisfy them. It generates "information" which is transmitted through the price system, guiding the allocation of resources through the market towards the satisfactions of those preferences. Competition is fueled by entrepreneurs who are "alert" to any new piece of information coming from the market and ready to use it. As information in the market is widely dispersed among participants, none of them has the "power" to determine the result.

This competition generates an efficient allocation of resources considering the knowledge available, where consumers guide the decisions of producers.

Nevertheless, in order for markets to work a legal framework is needed with norms that allow them to function. Basically, this framework is composed of the three fundamental principles selected by David Hume: the stability of possession (the right to private property), its transfer by consent (contractual freedom) and the fulfilling of promises (certain cultural or moral values).

It is affirmed though, that certain goods cannot be supplied by markets, they have the characteristics of what are called "public goods", with no possibility to exclude those who do not pay for them and non-rivalry in consumption. They could not be provided on a voluntary basis by markets and, therefore, should be supplied by government. Among those usually mentioned the legal framework is present.

Governments, nevertheless, are monopolistic by definition. Max Weber described them in this way:

> "Today, however, we have to say that a state is a human community that (successfully) claims the *monopoly of* the legitimate use of physical force within a given territory".[2]

As we can say that a monopoly in the market would be "inefficient" as long as the lack of competition allows it to charge "monopoly prices" for products and services of dubious quality, the same can be said of a government. Nevertheless, there could be in the marketplace just one supplier at a certain time, one that got such position by being more efficient than the rest, but could not charge "monopoly prices" since that would be a signal for competitors to enter the market and consumers would move to them; but the monopoly of government, being the monopoly of the use of force, by definition forbids the incoming of competitors. And when that happens it is usually called "war" or "internal sedition".

However, even if governments are monopolistic organizations not exposed to competition, they do compete with other governments at the international level, since resources have a certain degree of mobility and a capacity to decide where to go. And the "threat of competition" that prevents a monopolist to charge monopoly prices may be also at work in the competition among jurisdictions.

COMPETITION AMONG MONOPOLIES

The competitive market process generates efficiency by forcing suppliers to pay attention to the needs of consumers. They need to have the voluntary approval of consumers in order to make mutually beneficial exchanges. Within the realm of government actions this is not the case since such approval is not required, at least in a direct way. This decoupling between service and payment is at the root of the problem and as long as it exists the problem of the "Leviathan" will be present.

In this regard, the process of intra-, inter- and extra-jurisdictional competition acts as an additional mechanism to control power, since it sets limits to what governments can do without the explicit consent of citizens. As long as the mobility of factors exerts positive and negative pressures, it introduces a system of rewards and punishments forcing politicians to pay attention to those movements and act accordingly.

But we are talking about territorial monopolies, with imperfect (though growing) mobility of citizens and imperfect information with regard to costs and benefits in different jurisdictions due to the lack of prices for those services. As long as the individual is able to move, competition creates better conditions but, at the same time, we are far from the degree of competition in which an individual makes her choice just opting for one service or another.

Nevertheless, these movements exist and become more intense the smaller is the size of the jurisdiction in charge of the service. That is why the benefits of decentralization go beyond the knowledge of the specific circumstances of time and place allowing a proportional increase in mobility and, therefore, competition.

Exit and Voice

The market economy is highly efficient when people can initiate or terminate productive exchanges between them – that is, when they can "enter" or "exit" those relationships. If a certain good or service offered by a producer is considered "bad" compared to those offered by other producers, the consumer just exercises the "exit" option and selects one of the others. Producers are always pressed to be as efficient as they are compared to their competition. This is the basic logic of the marketplace as developed by Adam Smith.

This view was first extended to the analysis of the efficiency of local governments by Tiebout (1956), likening the consumer to the voter who, as he selects in the market what he considers to be the best product or service to satisfy his needs, selects a community "which best satisfies his preference pattern for public goods" (p. 183). According to Tiebout, at the central government level the preferences of the consumer-voter are given and the government tries to adjust to them [although assuming that governments have such a single goal would certainly be objected to by public choice authors]. Tiebout adopts from the neoclassical paradigm the concept of the "benevolent dictator" who just wants to achieve the common good.

On the other hand, his argument could be extended to competition among different "national" states as long as migration of resources is possible. Central governments would be subject to the competition of other national governments in the provision of services, something that migration trends tend to confirm. At the local government level, these would have their revenues and expenditures more or less fixed and the consumer-voter would move to the local government that best satisfies this patter of preferences. The larger the number of communities and the differences between them, closer the consumer will be to achieving his personal preferences, as in the market.

Therefore, the "exit" option takes the place of the market test making it sure that each community would have the system of revenues and expenditures reflecting the wishes of its citizens (p. 185). That is, as the market achieves "efficiency", competition among local governments also achieves it at that level of government. Tiebout paraphrases Samuelson saying that "each individual, in seeking a competitive buyer to get to the highest level of indifference subject to given prices and tax, would be led as if by an Invisible Hand to the grand solution of the social maximum position" (p. 189).

Authors in the Public Choice tradition do not assume the benevolent character of government and present the same Tiebout argument but with a different perspective. According to them, the logic of Adam Smith's analysis is that of the Federalist Papers. Both assume that individuals, including government officials, follow their own interest and try to use governmental power to achieve it unless they are restricted by the possibility people may have to protect themselves in other jurisdictions or to prefer officials from other levels or regions.

Some authors, such as Brennan & Buchanan ([1987]1997), Bish (1987), Buchanan (1995/96), Vaubel (1999), emphasize the process of competition among local governments through the "exit" option as a limit to the exploitation of citizens and companies by local governments. And Buchanan says that for such an option to work it would not be necessary for a large part of the population to exert it, but their effects would be felt even with a relatively small proportion of them. Even people and businesses that would never consider moving would be protected by the recognized existence of those marginally willing to do it. In that sense, federalism and decentralization would help to limit the chances of abuse by both a central government and local ones.

The analysis within the "exit" and "voice" framework was developed in the seminal work of Hirschman (1970). The author points out that economics focused in the "exit" mechanism promoting efficiency in the markets when the consumer decides to change her preference from a product or service to another, as well as when people leave a company. As a result, the firm's revenues fall, customers or members dwindle in number and managers are forced to find ways to correct the problems.

On the other hand, political science has concentrated in the "voice" mechanism, that is, the way individuals, as citizens, manifest their approval or rejection of certain policies, and proceed to elect their representatives.

Nevertheless, Hirschman points out the two mechanisms are working in both areas: "voice" is present in the marketplace when customers or shareholders directly manifest their approval or uneasiness for the quality of products and services to managers, and “exit” is also present in the political realm when citizens, through their mobility, move from those jurisdictions offering services of low quality or high cost to those with better offers.

Buchanan also affirms that even if citizens and business were not disposed to exert the “exit” option, the existence of small jurisdictional units improves the other option, “voice”, through the usual democratic vote since one single vote is more decisive within an electorate of 100 than one in a thousand or in a million. Besides, it is easier to organize a small group that may become a winning coalition in a small jurisdiction. Even if the “exit” option were not used, there is still the “virtual exit” which relates to the observance of the performance of other jurisdictions and the effects this may have in the internal political process. Even though exit was important, particularly in the case of Germany, the observation of other economies, cultures and politics in Western countries by the citizens of Eastern and Central Europe played an important role in the revolutions of 1989-91.

On the other hand, “exit” would not need to be “physical”, with the personal move of the individual or company in order for competition to exist. Kobayashi & Ribstein (1997) affirm the existence of different legal systems in a federal state creates potential competition among them, as long as people and businesses can choose the legal jurisdiction of their contractual relation. This is evident not only in international trade and finance where the two sides of an exchange in many cases choose the courts to which they will submit any differences in a contract; but also among states as the example of the incorporation of firms in the United States attests. Companies look for states with the best legal systems, which are usually different from those where they have their headquarters, even without having operations in it.

INSTITUTIONAL COMPETITION

We call “institutions” the rules that allow us to coordinate the actions of individuals in a society. They give us reliability with respect to the actions of others. Customs and practices give birth to the expectations that guide people, and the practices people follow are usually recognized as law. The authority of a legal system comes ultimately from a feeling that it is “correct” since it verifies expectations. From such a perspective on authority it comes clear that reciprocal agreements are the basic source of recognition of the duty to obey the law (Benson, 1989).

Institutions are created in order to complement the task of mechanisms such as reputation. In an extended community it would be very costly to keep everybody informed about the actions that lead to a certain reputation. Therefore, a system of private judges grew to promote the resolution of disputes and to supply the information strictly needed to allow the reputational mechanisms to work properly.

Take the case of traffic rules, where all drivers are better off with some convention, be it driving on the right or on the left. Repeated encounters will give birth to such a convention. And once it is established it will be very costly to change it, even though it may not be the most efficient. This is called *path dependence*, often related to examples like the QWERTY keyboard for typewriters still being used for modern computers or the VHS video standard (Ulrich, 1994).

From this perspective social institutions are the result of the regular non-planned actions of individuals in response to their problems. Institutions, norms, or conventions, can be of two kinds: formal and informal. Informal are those which we usually associate with "culture" or "ethics", transmitted from generation to generation through teaching and learning. The difference between them is just a matter of degree. We could imagine a continuum of taboos, customs and traditions at one extreme and written constitutions on the other. Societies have moved from less to more complex organization along such a path, associated with the more extended specialization and division of labor in more complex societies (North, 1993).

Their function, in the end, is to save on information costs with regard to the actions of others. In order for social relations to be ordered, actors must form expectations over the actions of others with a certain probability of being correct. In this sense, institutions are communication tools through which an individual, adjusting her conduct to a certain rule or institutions, sends information to others so they can guide their reactions to her.

This informational goal is similar to what Hayek attributes to the mechanism of prices, precisely one of the fundamental "institutions" that should facilitate coordination of actions aimed to solve the problems generated by scarcity (Hayek, 1945). He mentions other institutions that are the result of spontaneous evolution, such as language, money, property rights, trade, the *lex mercatoria* that still governs international trade and common law.

Race to the Bottom

There is a negative view of the process of inter-jurisdictional competition assuming the opposite, that it leads to a "race to the bottom", reducing governmental services to lower levels than those preferred by citizens. The necessary competitive actions by governments would generate "externalities" since a certain jurisdiction would improve the welfare of its citizens through fiscal competition, reducing taxes and attracting resources, which would be lost by other jurisdictions, whose citizens would see their welfare reduced (Zodrow & Mieszkowski,1986; Wilson, 1986).

If a government were not exposed to competition, it is stressed, it would raise taxes to the point where the provision of public goods would be optimal. These models, based on the efficient provision of public goods theory by Paul Samuelson affirm that, in the absence of competition, public expenditures would reach the point where the marginal benefit of one additional unit of expenditure would be equal to the marginal cost of supplying it.

The existence of inter-jurisdictional competition would distort such an equilibrium, since it would be a matter of considering not only the direct cost of an additional unit of expenditure, but also the indirect cost resulting from a loss of resources to other jurisdictions. Such a situation would generate a suboptimal equilibrium.

Any government starting a "competitive" policy would attract resources and improve the situation of its citizens *vis-à-vis* others. But this equilibrium would not be stable, since competitive replies are expected from others in a race leading to a generalized reduction of valuable government programs. Considering the world as a whole, we would be in a situation where public expenditures are suboptimal since programs with a marginal benefit (MB) larger than its marginal cost (MC) would be relegated.

From this it is derived the need to "harmonize" regulatory and fiscal policies, particularly the regulations on markets (products, labour) and tax rates.

Nevertheless, these theories face several problems:

1. The amount of global capital is considered fixed, so what one country gains the other loses, and no account is taken of wealth creation coming from higher level of savings and investment. The effects of distributing the cake are discussed without considering its growth (Teather, 2005).
2. Only the relation between MB and MC for governmental programs is considered but they are not compared with the MB and MC of private projects coming out of resources freed from a reduction in the tax burden, that is, the opportunity cost of those resources.
3. Probably the weakest point is the assumption that government expenditures are perfectly efficient, that it is possible to know the "social" MB and MC that maximizes the preferences of citizens, that the government goal is to achieve such maximization and, lastly, that is able to do that, without regard to all the contributions of "public choice".

But if governments are not perfectly benevolent and act as every monopolist, the level of government expenditure will be far from optimal, and submitting them to competition would help to control its excesses and to reach a higher level of efficiency than otherwise would be. In that sense, competition would move closer to an optimum rather than farther away.

GLOBALIZATION AND COMPETITION

What we now call "globalization" is a phenomenon coming from a wider mobility of resources as a result of technological advances and the removal of regulatory barriers limiting it.

Since 1987 exports have grown from 16 to 27% of the world economy, foreign direct investment has tripled and financial investment quintupled. The number of tourists has more than doubled in the last two decades. International communications have exploded: phone international traffic has grown from 40 billion minutes in 1991 to 140 billion in 2004, users of the internet were 900 million in 2005.

Consumers now have more options and know of other possibilities. This increases competition between producers which, in time, encourages creativity, innovation and an increase in productivity. Such competition forces producers to search for places offering the best conditions for production, which are none other than Hume's three laws.

Globalization, then, submits countries to competition, and they compete by offering "institutional frameworks" to attract resources that now have an accelerated mobility, as well as to retain their own. Countries that offer these conditions receive resources, those who do not, expel them (people, capital, ideas, innovations, and technologies).

What are the elements of sound institutional frameworks and how does Latin America fare in each case?

1. Rule of law

   Legal structure and respect for property rights. This is a fundamental aspect, one of the three Humean laws and quite easy to understand. As long as there is no adequate legal structure allowing the defense of property, any abuse is possible. The variables considered here call attention mostly to property in the form of goods other than body and mind. Respect for human rights will be considered later with another index, but it is important to understand that if justice does not work to protect this right, if there is no independent and impartial justice with regard to citizen's property, most probably there will not be defense of their human rights.

   Robert Barro (1994, 1996a, 1996b) has studied the impact of the rule of law on the economy and, indirectly, in democracy. The methodology used takes an index made by Political Risk Services, on a scale of 0 to 6, transform it into another from 1 to 0, where the best respect of rights represents an index of 1.0 as is the case of OECD countries, and the lower is zero. No country scored zero in 1997, but several, such as Ethiopia, Guyana, Haiti, Sri Lanka, Yugoslavia and Zaire, had done so in previous years. The general index showed an average of 0.50 in 1982 where it stayed without many changes up to 1991. It reached 0.71 in 1996 and 0.70 in 1997.

Barro concludes from his regression analysis that the evolution of voting and legal rights is in great measure independent. Nevertheless, the evolution of the indexes shows a positive correlation over time, which could be explained by economic growth. But, the truth is independent improvement with respect to legal rights would stimulate economic growth, leading to an expansion of voting rights. The relationship would be, then, the following: a betterment of legal rights promotes economic growth, and this brings with it a strengthening of voting rights.

2. Voice and accountability

We mentioned before the concepts, developed by Albert Hirschman, regarding the way people express their preferences, which can be grouped in two categories: “voice” and “exit”. Voice includes all kinds of ways through which people express their beliefs and opinions, including, of course, voting and any kind of consultation such as referenda, plebiscites, ballot initiatives, town hall meetings, assemblies, as well as political rallies, picketing, articles written in newspapers, opinions in the media, letters to the editor and a number of other actions.

3. The size of government

Its importance comes from understanding that the lesser the role played by individual decisions and markets in order to allocate resources among the production of several products and services, the larger the discretion of government officials will be in the areas subject to their decisions. This generates a low institutional quality since it tends to deviate the attention from functions government must perform to others it does not, leaving unattended those that are fundamental to its purpose (justice, security). The larger the size of government, the larger also are the chances for corruption and the growth of lobbying, since any activity is under its supervision.

A larger government share also increases its political power, which in Latin America tends to be concentrated in the figure of the popular leader or “caudillo” who controls social activities. This results in low institutional quality since it becomes the “rule of the leader" instead of the "rule of the law". This situation brings very little stability since leaders change their policies or, inevitably, they are changed themselves and institutional uncertainty prevails.

4. Macroeconomic stability
   Stability depends upon the existence of fiscal deficit or surplus, the national savings rate, inflation, real effective exchange rate, the spread between rates for savings and loans and government debt. In this case the perception with regard to the quality of government expenditures is singled out. On the other hand, the existence of fiscal deficit or surplus and the size of government debt are clear indicators of the quality of management of public revenues and of adequate institutional control over expenditures and debt.

5. Sound Money
   It follows from the last. Without sound money capital, savings and the outcome of one's own efforts are lost. The goal of institutions is, precisely, to protect them, and "money" is a fundamental institution that allows us to multiply exchanges and cooperation within the marketplace. If government first imposes the obligation to use its money and later deteriorates its value while banning citizens from using alternative currencies, it undermines an institutional element of utmost importance. The loss of currency value ends up corroding institutions since it is a tax not voted by any parliament that redistributes income from creditors to debtors, confiscating property and violating the economic freedom of citizens.

6. Freedom to trade
   None of us questions the benefits that accrue to citizens from Sao Paulo who trade goods and services with those of Rio de Janeiro, or those of Queens with those of the Bronx. Anyone interfering with these transactions would be violating the rights of the two parties to freely exchange the outcome of their work.

   Nevertheless, for some reason when it is the case of an Argentine citizens trading with a Peruvian or a Guatemalan the situation is different and the individual is no longer able to trade, even though the benefits of trade are the same for both sides as in the first examples.

   Barriers to international trade are among the main sources of institutional deterioration because they generate incentives for certain groups to get "privileges" through protectionist tariffs, quotas, and other trade barriers. Institutional deterioration in this case comes from the very word since "privilege" comes from "private law", the opposite case of general law that applies to anyone.

Trade barriers also create all kinds of corruption, in people from customs offices to legislators to the government officials who sanction them.

7. Regulations

Laws, in general, must be addressed to protect the rights of citizens, their property, their freedom and the fulfillment of contracts.

But regulations have another sense. They can interfere with the transactions between individuals, introducing goals that are not those of the contracting parties in order to achieve other aims that the regulator supposedly knows and that he presumes will be superior to the benefits of those transacting.

Nevertheless, regulations ends up achieving other goals that are far removed from those even the well-intentioned regulators tried to achieve. In the same way, interference with foreign trade create privileges, reducing or eliminating competition in order to get higher profits.

It is usually argued that regulations are needed in order to "control" the market, but the truth is that the best control we can have is that coming from the consumer and her capacity to choose. The power to select one product or service or another brings suppliers into competition, forcing them to get their approval by adapting their products and services to the desires of consumers. Regulation takes control from the hands of consumers and places it in the hands of government officials, increasing their power. Even if they had the best intentions they cannot have the information needed for proper decision-making. Besides the potential for corruption, this deflects government's attention from the main services it should be providing.

8. Corruption

Corruption is defined as the abuse of official positions for private benefit. It is a clear indicator of low-quality institutions, abuse of power, and the absence of the rules that the market needs to work properly. There could also be corruption in economic activities in the private sector, but they are of a different nature, and there are sanctions for such actions. In private business, when an employee takes a bribe, he essentially hurts the business owner, but when this happens with a government employee, the burden falls on all citizens. Besides, there is an important role for reputation in the market, and any corrupt businessman will have a hard time finding partners for a business transaction unless they are as corrupt as he (e.g., organized crime).

Besides, even though we cannot define a causal link, corruption and poverty typically coincide. Moreover, the level of poverty is not the determinant of corruption. The degree of participation of government in the economy is. The larger it is, the higher the corruption, because a large number of activities require governmental authorization. This monopoly power is the source of corruption. An example, if a government official must give a permit in order for someone to write a book, this immediately creates the possible existence of a “price” to get the sancion. But if anyone can write a book without a permit, the “source” of corruption has disappeared. It is no longer a matter of whether an official is corrupt or honest, but simply that his authorization is no longer needed.

9. Freedom of the press
   The free circulation of ideas is, besides a basic human right, of the greatest importance for the quality of institutions, consisting on the possibility to issue opinions related to the institutions themselves and the authorities designated to manage them. In this sense, freedom of the press is a key aspect for the limitation and control of the power granted to government officials and, as such, freedom of the press is a weighty component of institutional quality.

   It is certainly difficult to measure “institutional quality” in a country since it is more of a “qualitative” concept, determined by very different variables. Nevertheless, there are a number of comparative indicators that allow us to have an idea of what we are talking about, aggregating a large number of variables. The ones that will be considered here are:

Rule of Law

We measure the rule of law using part of a set of aggregate indicators based on hundreds of specific and disaggregated individual variables measuring various dimensions of governance, taken from 33 data sources provided by 30 different organizations. The data reflect the views on governance from the public sector, the private sector and NGO experts, as well as thousands of citizen and firm survey respondents worldwide. In this case it measures the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, the police, and the courts, as well as the likelihood of crime and violence.

Voice and Accountability

Also from the World Bank Governance Indicators, these cover 212 countries and are published every two years, the last data considered being from 2005. They are built taking into account hundreds of variables coming from 37 different sources, by 31 different institutions.

Freedom of the Press

The Report on Freedom of the Press by *Freedom House* evaluates the degree of freedom in each country, including written press, radio, television and internet. Qualifications are based in three categories: the legal framework within which the media act, political influences on journalism and access to information and economic pressures over content and dissemination of news. The Report qualifies countries between zero (most free countries) and 100 (least free countries) for 194 countries. Among these, 75 (39%) are considered free, 50 (26%) are partially free and 69 (35%) are classified as not free. In terms of population, 17% of the world's inhabitants live in countries with a free press, 38% with partially free and 45% with not free.

Corruption Perception Index

This is the recognized index by Transparency International, measuring existing perceptions for corruption in 163 countries. It consist of a poll reflecting the perceptions of businessmen and analysts from different countries, which are qualified with regard to the degree of perception of corruption among government officials and politicians. It is based on 16 polls carried out by 10 different institutions, and for a country to be qualified it must participate, at least, in three of them. That is the reason why some countries, which are arguably the most corrupt, are not included in the rankings. However, all of the countries of Latin America and the Caribbean are present.

Global Competitiveness Index

Published by the World Economic Forum, this index is composed of three sub-indexes: Basic Requirements (institutions, infrastructure, macroeconomics, health and primary education), Efficiency Enhancers (higher education and training, market efficiency, technological readiness), and Innovation and Sophistication Factors (business sophistication and innovation), calculated on the basis of hard data and survey answers. Countries are also ranked according to per capita income, with more weight given to the Basic Requirement in lower-income countries, while more weight is placed on Sophistication and Innovation Factors for higher-income nations.

Doing Business

This indicator is a result of a program started by the World Bank in order to create a database with objective measures of the impact of economic regulations on business activities, applied presently to 155 countries. In general terms, it aims to evaluate the regulatory costs of any kind of trade or business activity.

Indexes of Economic Freedom

There are two indexes of this kind: one developed by James Gwartney from Florida State University and Robert Lawson from Capital University with William Easterly from New York University, published by the Fraser Institute from Canada and using contributions from many think tanks throughout the world; the other by Tim Kane and Kim Holmes from the Heritage Foundation and Mary Anastasia O'Grady from the Wall Street Journal, published by these two institutions, also using information from a multitude of institutions across the globe.

Even though these competing indices have similar goals, they differ slightly in their methodology, in the variables considered and, therefore, in their results. However, both utilize reports and statistics from prestigious international organizations and think tanks.

INSTITUTIONAL QUALITY INDEX

It is not easy to reduce the evaluation of the quality of institutions to a single index. So far, we have tried to present different indicators that, in one way or another, reflect different aspects showing their quality in a more or less direct way.

The next step will be to compile such information in order to get a new index that we will call Institutional Quality Index. In order to construct it, we follow a simple methodology, the same one used for the Doing Business indicator. Our composite index is a simple average of the rankings in each of the ten indicators discussed above. The following example illustrates[3]: The ranking on starting a business is the average of the country percentile rankings on the procedures, days, cost and paid-in minimum capital requirement to register a business. It takes 5 procedures, 5 days and 2.9% of annual income per capita in fees to open a business in Iceland. The minimum capital required is 17% of per capita income. On these 4 indicators, Iceland ranks in the 7th, 1st, 8th and 48th percentiles. So on average, Iceland ranks in the 16th percentile on the ease of starting a business. Once this average is taken, the same methodology is applied for all other indicators, creating an average of the relative positions for each country.

In our case, the methodology is similar, except we use the Doing Business index as one of our inputs to construct our index. As the indexes considered have a different number of countries, we do not consider the position a specific country gets (for example, position 58 or 97) but the percentile position. Therefore, all positions were transformed into percentile values within the index under consideration. The final result is the average of percentile positions. For their inclusion in this ranking we only considered countries that were evaluated in at least four of the constituent indexes.

The strength of a composite indicator is that, because it can incorporate information from more than a single source, the margin of error is smaller. Nevertheless, those margins are still large and we must be cautious in our analysis (Kaufmann et al., 2005).

This indicator does not give us a "qualification" for each country, that is, it does not inform us how far or close it is from an ideal. It only gives us a relative position. The country in the first place does not have a perfect rating. It should not be viewed as an ideal country, but rather as the one with the best characteristics at this point in time.

In a way, we are trying to replicate a mechanism of "information aggregation" complying with the conditions needed for it to give valuable information. These conditions are (Surowiecki, 2004):

- Diversity of opinion (each person should have some private information, even if it is just an eccentric interpretation of the known facts)
- Independence (people's opinions are not determined by the opinions of those around them)
- Decentralization (people are able to specialize and draw on local knowledge)
- Aggregation (some mechanism exists for turning private judgments into a collective decision)

The indicators selected were elaborated both using hard data and the opinions of experts, both from international agencies as from research institutes or think tanks, allowing for such a diversity of opinions. Nevertheless, we have not attempted to accumulate the result of whatever index is available, but their selection comes from the perception that they evaluate relevant aspects to measure the quality of institutions, as explained above. The Institutional Quality Index, therefore, shows the following twenty highest-ranking countries among the 184 countries we ranked:

Position	Country
1	Switzerland
2	Denmark
3	Finland
4	New Zeland
5	Iceland
6	Sweden
7	Luxembourg
8	United States
9	Netherlands
10	United Kingdom
11	Canada
12	Ireland
13	Australia
14	Norway
15	Germany
16	Belgium
17	Austria
18	Japan
19	Estonia
20	Hong Kong

It is no surprise to find these countries – they appear high in most of the constituent rankings. Nevertheless, some conclusions flow from a review of the results. First, compared to the Indexes of Economic Freedom, some countries fall in their relative positions due to a mediocre performance in indicators such as "Freedom of the Press" or "Voice and Accountability". Examples of these are Hong Kong, Singapore and some Arab countries. Second, small countries, such as some islands on the Caribbean or the Pacific, rank higher than larger countries such as China or India. This could be explained by the fact that their smallness has forced them to be open economies in which contracts and property rights are enforced, since their economies would not be self-sustainable if closed. Third, the "heritage" of legal systems such as the British "common law" shows that some countries could get a better performance of justice as shown by, for example, the high qualifications of some Caribbean countries as compared to others in Latin America that inherited the legal systems of Spain or Portugal.

With regard to the Western Hemisphere, we preferred to include here all countries, not only those "Latin American", because they are all relatively young countries and in the same region. Certainly, they have inherited different political and cultural traditions, as mentioned before, but that does not impede countries such as Chile, Uruguay or Costa Rica from reaching relatively high positions.

The complete results for hemisphere in 2006 appear in the following table, with the each country's global ranking listed in the "position" column.

Country	Position
United States	8
Canada	11
Chile	22
Bahamas	23
St. Lucia	25
St.Vincent and the Grenadines	29
Barbados	32
Dominica	44
St. Kitts and Nevis	47
Uruguay	50
Antigua & Barbuda	51
Costa Rica	54
Belize	56
Jamaica	58
Grenada	59
Trinidad & Tobago	63
El Salvador	65
Panama	68
Mexico	75
Peru	80
Brazil	90
Argentina	93
Nicaragua	95
Suriname	97
Colombia	100
Guatemala	109
Guyana	111
Honduras	113
Dominican Republic	114
Bolivia	118
Paraguay	128
Ecuador	133
Venezuela	161
Cuba	164
Haiti	165

Venezuela, Cuba and Haiti are in the last places by a wide margin. Unfortunately, there is little likelihood that they will improve soon. Cuba may have them with the transition after Fidel Castro left direct control of government, but expectations for Venezuela are mixed. Similarly, the next lowest-ranking countries are Ecuador and Bolivia, where attempts to manipulate constitutions and institutional frameworks will probably deteriorate their institutional quality.

The three largest countries in the region (Mexico, Brazil and Argentina) show a poor set of characteristics, even though Mexico seems to have moved away of the pack after tightening its association with its northern neighbors.

The smallest countries occupy interesting positions. These include not only the Caribbean countries already mentioned, but also Uruguay, Costa Rica, Panama and El Salvador. The first two have long democratic traditions and "moderate" political environments. The latter two have gone through quite traumatic periods in their recent history, but they have been able more recently to restructure and strengthen their institutions. Also in this group is, of course, Chile, which shows continuous signs of institutional strength to the point of positioning itself among the best in the world.

Finally, the United States and Canada, both large countries with open economies and very solid institutions, provide an example to the other large countries in the region regarding on how wealth can be generated through a solid institutional framework.

CONCLUSIONS AND RECOMMENDATIONS

Faced with institutional competition, accelerated by the process of globalization, countries have basically two options: participate in it and get their benefits or isolate themselves and be left aside. What are those benefits? Let us examine five things that happen to countries that try to avoid global integration. First, a country closed to external institutional competition is a country closed to trade, losing the benefits of commercial exchanges Second, the country would lose its own resources (particularly human) looking to settle in other jurisdictions. In order to avoid this, it would have to curtail this exit in an authoritarian way (Cuba, North Korea). Third, it would not attract external resources (investment, technology), which are scarce and become much scarcer even in closed countries. Fourth, it would condemn its people to low incomes and poor quality of life. It is not strange that the last-positioned countries in the ranking also show lower per capita incomes. Fifth, the absence of external competition would increase the likelihood of a dictatorial government, further reducing the "internal" competition that democracy promotes.

In the end, a country that closes itself to institutional competition loses the benefits of progress and condemns its population to a lower quality of life, not only in terms of income, but also in restricting the free exercise of their rights. In contrast, countries that properly accept their roles in the international context are pushed by competition to modernize their institutions, reaping the benefits of trade, receiving resources, technology and investments, promoting a better quality of life and a better respect for individual rights.

It becomes clear that to improve the institutions of a country is no easy task and when it was attempted without taking into account existing local traditions, the results have been complete failures. Nevertheless, there are good examples to consider.

Such is the case of Estonia, for example, ranking 19th in the IQI. Estonia rejected left socialism only some 15 years ago after decades of Soviet domination. Similarly, Lithuania is in position 35 and Latvia is at 38. Chile departed from a state-controlled economy first to consolidate modern and stable institutions, only later toppling its military dictatorship. Portugal, ranked 24, resolved those same problems. As indicated above, there is success in some Caribbean small islands. These countries typically are not endowed with natural resources and are very small. Examples are St. Lucia (25) and St. Vincent & the Grenadines (29). The explanation bears repeating – their small size has pushed them to open to the world, leading them to improve their institutional quality.

There are also negative examples, particularly in Latin America. Haiti has never achieved even a small degree of institutional control of power. Venezuela, presently experiencing deteriorating quality of its democracy, hearkens to the decades when Latin America was characterized by military dictatorships. For example, Argentina, which offered such great promise at the beginning of the twentieth century, fell into a downward spiral of military governments and economic crises.

And even though it is not easy to extrapolate conclusions and recommendations from one country to another, considering the specific characteristics of their historical evolution and the values prevailing in each of them, there are some steps that would remove the barriers to institutional competition, enhance the mobility of productive factors and promote institutional improvement.

Two changes are necessary to promote "external" competition (attracting resources from abroad). First, without a doubt, is the "rule of law". The rule of law refers not merely to the enforcement of whatever rules the power of the moment approves, but to enforcement of the Law with capital letters – respecting the rules that protect individual freedom, the right to property, the enforcement of contracts, and limits on the power of the state. Also important are international treaties allowing citizens to defend their rights in supra-national forums. Second, the removal of barriers to trade, investment and free movement of people is crucial. Unilateral opening is desirable in itself, as is active participation in international economic negotiations (WTO). International treaties for the protection of investments, property rights and contract enforcement must be adhered to.

Complementing external competition, it is equally necessary to promote "internal" competition, which allows the mobility of resources within a country. Again, two categories of actions are needed. First, countries must decentralize. Both in the case of a "unitary", and particularly in a "federal" government, the reassignment of authority to lower levels of government is essential. Devolution of authority must include control over both revenues and expenditures, in order to promote and widen the degree of competition and facilitate the mobility of resources toward their most-productive employment. This requires in many cases significant fiscal and tax reform to reassign resources and functions to lower levels of government. Second, governments must deregulate by removing existing barriers against movement of economic activity from one local or regional jurisdiction to another (e.g., removing restrictions related to permits, licensing, etc.).

Obviously, this is only a set of general principles suggesting removal of barriers to institutional competition, with the goal of encouraging the evolution of institutions adapted to specific circumstances. However, reforms should be based on successful practice elsewhere.

Application will be different in each case, but there are diverse good examples from which to draw. Switzerland has a very decentralized institutional structure with many decisions taken at the canton or local government level through mechanisms of direct democracy, with cantons competing among themselves to attract resources through differing tax rates and quality of services. The government consists of a collegiate executive power of seven members appointed and supervised by an Assembly, from which a Head of State is appointed for a year. Denmark is a constitutional parliamentary monarchy which, at the beginning of 2007, replaced 5 regions with no fiscal power for 13 cantons, reducing the number of local governments from 270 to 98 (it will be interesting to see whether this will reduce the degree of competition, causing Denmark to fall in future ISI rankings). Finland is a parliamentary democracy with 416 local governments with a high degree of autonomy. New Zealand is also a parliamentary democracy with a constitutional monarchy.

In the same way that competition assures the supply of the best products and services and the best prices in the market, greater competition among governmental monopolies may promote a better alignment between the preferences of citizens and governmental decisions, resulting in better (public) goods and services at better prices (taxes) in the market.

NOTES

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