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# INSTITUTIONAL QUALITY AND FIRMS' PRODUCTIVITY IN EUROPEAN REGIONS

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## ABSTRACT

We investigate the relationship between regional institutional quality and firms' productivity over the 2010-2014 period, by regressing a measure of TFP for European manufacturing SMEs on a region-level index of institutional quality and its components, rule of law and government effectiveness. We find strong evidence that better local institutions help SMEs to become more productive. Besides, the impact of institutions comes out to interplay with some firms' characteristics such as size, age, human capital and productivity level, as well as the firms' operating sector. These findings have important implications for the definition of suitable strategies to foster economic growth in EU regions.

*JEL code:* D02, M48, O52

*Keywords:* Institutional quality, SMEs' TFP, regions, Europe.

## INTRODUCTION

Development accounting exercises have shown that per-capita income growth across countries can be explained by both differences in the amount of production inputs (Caselli, 2005) and changes in productivity. In particular, the aggregate and individual firms' Total Factor Productivity (TFP) has been acknowledged as a key driver of long-run growth, and a crucial mechanism for increasing living standards, since the seminal work of Solow (1957) and Abramovitz (1956) up to more recent analyses (Caselli, 2005; Hall & Jones, 1999; Syverson, 2011).

However, what are the determinants of TFP, and specifically of small and medium-sized enterprises (SMEs) TFP? An interesting taxonomy distinguishes between *microeconomic* and *context* factors affecting firm productivity. The former label is used for factors connected to firms' features, and managers' or owners' decisions; the latter one for those linked to the outside environment, such as more competitive and contestable markets, more favourable conditions to innovation, inter-firm cooperation and positive spillovers, and so on. Often, a positive and important *context* factor is also recognized in the good quality of institutions operating in the geographical area where the firm is located. Actually, local institutions should be particularly relevant for SMEs, usually strongly rooted in the territory where they operate.

This paper investigates the relationships between local institutional quality and SMEs' TFP to deepen our knowledge on a particular aspect, which is little investigated by the extant literature, i.e. heterogeneity in institutions' effectiveness. Indeed, our analysis builds on the idea that institutional quality might be considered in a broad sense as a peculiar kind of productive input, in principle characterised by either complementarity or substitutability with other firms' or environment's favourable characteristics. If institutional quality is complementary to those features, the latter should boost the beneficial influence of institutional factors on TFP. Vice versa, if institutional quality tends to substitute for the lack of some firms'/environment's favourable conditions,

we should record a decreasing influence of institutional quality on TFP, when conditioning on these factors.

To provide evidence on such contrasting propositions, we test whether the relationship between institutional quality and SMEs' TFP is moderated by individual characteristics (such as productivity performance, age, size, and human capital employed), the technological level of the industrial sector which firms belong to, and the economic performance of the region where the firm is located.

Our analysis takes advantage of firm-level data: we employ a measure of TFP of about 6,500 manufacturing firms located in seven European countries (Austria, France, Germany, Hungary, Italy, Spain, United Kingdom) for the period 2010-2014, retrieved from the EFIGE survey, containing information collected through direct interviews to a large representative sample of manufacturing companies.

To account for local institutional endowment, we consider the overall region-level (NUTS2) index *EQI* built by Charron et al. (2014), as well as its components named rule of law (*RUL*) and government Effectiveness (*GOV*), which focus on more specific aspects of institutional quality, respectively capturing the confidence of agents in the framework of legal rules imposed by the government, and the effectiveness of public intervention in enforcing those rules and thus promoting a favourable regional business environment. The adoption of specific indicators of particular institutional aspects, together with the overall index, is another distinctive feature of the paper, justified by the conjecture that the presence of a well-defined legal framework in terms of contract fulfilment, activity of magistracy and police, and low crime levels on one side (rule of law), and the government ability to promote and implement effective regulatory interventions on the other (Regulatory quality) are likely to be more important in shaping firms' incentives and opportunities to reach high productivity levels than the other two pillars of *EQI* (Voice and accountability and Corruption), which are essentially defined in terms of press freedom and bribery

in public school and health and medical public services. The review in the Related Literature section shows the importance that the literature has recognized to the institutional dimensions of rule of law and government effectiveness.

Another qualifying element of the paper is the regional scope of the analysis, contrasting the prevailing approach which studies the effectiveness of institutions at a country level. As argued by Charron et al. (2014, p. 70), that choice follows the belief “that national differences matter more than subnational ones”, whereas actually “the latter tend to trump the former quite frequently”. Indeed, inspection of the European regional ranking provided by Charron et al. (2014) shows cross-cutting diversity in institutional endowment, with differences among regions, even within the same country, being often larger than those among countries, so as to depict a dualism between high-quality-institution core regions in Central and Northern Europe and low-quality-institution peripheral regions. In some cases the inter-regional variability is really huge; for example, in Italy “the gap between Bolzano region, which ranks near the top of all EU regions, and Campania, which is among the lowest, is wider than the gap between the countries of Denmark and Hungary” (Charron et al., 2014, p. 70). Given this sub-national heterogeneity, the regional focus seems us to be suitable to exploit variability that international comparisons would not take into account, thus yielding additional insights on incentives and opportunities supplied by good institutions for better firm performances. Several authors share this view, showing that institutional quality may significantly vary within countries (Tabellini, 2010), with relevant consequences on several economic outcomes, firms’ TFP included (Lasagni et al., 2015). In the same vein, Audretsch & Keilbach (2004) focus on the central role of the regional institutional context in fostering and steering firms’ access to the market. For developing countries, evidence about heterogeneity in institutional endowment at a subnational level is available as well (Meyer & Nguyen, 2005).

Consistent with theoretical and empirical literature, and regardless of the indicator of institutional quality we use, our findings support the hypothesis of a significant positive impact of institutions on firms' TFP. Besides, institutions seem to be more important in fostering TFP for smaller, younger, less human-capital intensive firms, and those operating in less technologically advanced industries, thus suggesting that well-designed and more effective government institutions may play a compensating role with respect to firms' individual factors of weakness. This indication is confirmed by the evidence provided by a quantile regression analysis showing that good institutions matter more for less productive firms.

The paper is organised as follows. The next section provides an overview of the literature on institutional quality as a determinant of TFP differentials and some more specific aspects related to issues addressed in the paper. After, we present our research hypotheses, the empirical model and estimation methods. The successive section reports the main results, while the final one summarises the main conclusions and discusses some policy implications.

## RELATED LITERATURE

In the economic literature context factors connected to geographical, historical, cultural, social, political and administrative peculiarities, and in particular institutional features, are widely recognised as determinants of the economic success or decline of countries, regions and individual firms. Concerning, in particular, the relationship between local institutional quality and firms' productivity, many authors have dealt with a variety of channels through which institutions affect the operating environment and ultimately firms' performance.

Syverson (2011) and Chanda & Dalgaard (2008) identify the presence of spillovers and the degree of competition as the main channels through which context and institutional factors impinge on the level of business productivity. In this interpretation, spillovers basically operate

through incentive mechanisms: they encourage companies to innovate and adopt new technologies (Nguyen & Jaramillo, 2014) and to invest more in R&D (Griffith et al., 2006), shorten the technology distance (Bloom et al., 2013), and accelerate the process of convergence to the productivity levels of the leader in the domestic market (Bartelsman et al., 2008). Issar et al. (2017) show a positive effect of institutions on TFP, by means of an increase in efficiency. Other related studies (Bloom & Van Reenen, 2010; Fernandes, 2007; Verhoogen, 2008) focus on the relationship between intensity of competition and productivity. Greater competition allows the best companies to gain larger market shares at the expense of less efficient firms: the so-called “Darwinian selection of the market” rewards the most competitive, dynamic, flexible and innovative producers. Also, competition creates greater opportunities for comparing performance, making it easier for owners to monitor managers (Nalebuff & Stiglitz, 1983). Also, improvements in productivity may generate higher revenues and profits in a more competitive environment, where price elasticity of demand tends to be higher and, since more competition is likely to raise the likelihood of bankruptcy at any given level of managerial effort, managers have to work harder to avoid this outcome (Aghion & Howitt, 1998). An additional effect of greater competition on firms’ productivity may stem from the increased incentive for workers, provided that product market rents are shared with workers in the form of higher wages or reduced effort (Haskel & Sanchis, 1995).

Strictly institutional factors are those related to the quality of the legal and political system. The rule of law and the effectiveness of government policy have been recognised to establish ground rules – and then economic incentives – shaping choices, activities and strategies of utility-maximising entrepreneurs (North, 1990; Urbano et al. (2019); Williamson, 2000). The presence of a secure and well-defined legal framework and an effective local government reduces uncertainty and transactions costs, facilitates production and exchange, promotes accumulation of physical and human capital (Nifo et al., 2017; Rodrik et al., 2004), increases mutual trust and

social capital (Efendic et al., 2015), attracts ambitious high-growth firms (Estrin et al., 2013), encourages firms to operate on a larger scale and with a longer time horizon (Aron, 2000), to use better technology and to invest in knowledge creation and transfer (Loayza et al., 2005).

As these institutional dimensions contribute to well-defined property rights, they encourage business activities, because investors tend to seek places where contracts are enforced and clear, so that business relations with the parties involved in the commercial transaction are relatively safe and the risk of not recovering their funds and owing the results of their investments is reasonably low (Acemoglu & Robinson, 2008). If the law is perceived as clear, fair and easily enforceable, right incentives arise to invest and accumulate physical and human capital (Rodrik et al., 2004) and boost economic growth and development (Demirgüç-Kunt & Maksimovic, 1998). Largely positive effects can be associated to the implementation of incentive programs combining the gains of economic operators to obtain particular standards of operational efficiency (Knittel, 2002), similar to those of the programs of product market regulations in OECD countries (Arnold et al., 2008), or privatization programs in Eastern European countries (Brown et al., 2006). On the other hand, in countries and regions with a high risk of expropriation and insecure property rights or where there are crime, violence, corruption and ineffective government intervention, investments tend to be lower (Anderson, 1999). Also, poor or inadequate regulation can create perverse incentives that reduce productivity (Bridgman et al., 2009).

A peculiar channel through which institutions may impact on firms' productivity is connected to the stimuli supplied to entrepreneurship. According to Bosma et al. (2018), institutions somehow coordinate entrepreneurs' activities by determining whether, how, and under what conditions the latter can get access to the production inputs labour, finance and knowledge. Levie & Autio (2011) argue that better institutional endowment increases returns from business activity compared to employee work, encouraging individuals to invest in entrepreneurship. Audretsch et al. (2019) underline the role of institutional environments conducive to increasing the success for



newly established ventures (the so-called entrepreneurial ecosystems) demonstrating that the quality of institutions, both formal and informal, has a relevant marginal effect on quality and quantity of entrepreneurship.

Many other authors (Agostino et al. 2019; Audretsch & Keilbach, 2004; Ghio et al., 2015; Acs & Sanders, 2013; Hayter, 2013) emphasise different reasons to recognise a crucial role to regional institutions in entrepreneurship and firms' entry. Finally, it is worthwhile recalling that the rule of law (Efendic et al., 2015; Estrin et al., 2013) and regulatory quality (van Stel et al., 2007; Bjørnskov & Foss, 2008) are identified as institutional dimensions particularly relevant to entrepreneurship.

Finally, concerning the relationship (complementarity versus substitutability) between institutional quality and other determinants of firms' performance, ascertaining whether the benefits granted by good institution are larger or smaller according to the firm's size, age, human capital endowment and operational sector is basically an empirical matter, since from a theoretical viewpoint the institutional *macro* factor might act both as a complement and a substitute of individual *micro* factors. Considering, for example, human capital, a highly educated workforce may better exploit the opportunities supplied by a better institutional context, but the relative gain in terms of differential productivity from (say) higher public administration efficiency and lower criminality might be higher for firms with little skilled workers. To our knowledge, the issue has been little explored, and mainly by managerial literature. According to Porter (1980, p. 3) since public policies and the institutional context are much relevant to business strategy and performance, "the differing abilities of firms to deal with them" should matter a lot. In this view, the most capable firms are expected mostly benefit from a favourable institutional environment. In the same vein, Teece (1986) points out that property rights protection and a proper regime of appropriability most needed by highly innovating technological industries, so that good institutions are especially beneficial for advanced sectors. Against the reasons in favour of the complementarity hypothesis,

other studies document cases where a substitution effect arises between institutional quality and other inputs, highlighting that the former matters more when firms conditions are on average worse. For example, with reference to the case of China in 1998-2009, Lee & Lee (2019) show that the institutional development impact more on the productivity of national private-owned than foreign-owned companies, despite the fact that the latter can share better technical and managerial knowledge with their parent companies located in their home or developed countries. More generally, Kim & Lee (2009) find that institutional quality (and secondary education) results in being more growth conducive for low-income than high-income countries, and at a sub-national level Ma et al. (2013) document that local institutions affect foreign subsidiary performance in China more in the less developed area. Summarising, the sign of interactions between institutions and other variables relevant to firm performance may in principle go either direction so that ascertaining its course is basically an empirical matter.

#### RESEARCH HYPOTHESES, EMPIRICAL MODEL AND ESTIMATION METHODS

Our research hypotheses, consistent with indications of the literature surveyed above, are the following:

H1: Local institutional quality should be positively associated with SMEs' TFP thanks to a more secure and well-defined legal framework, lower transactions costs and stronger incentives to accumulate physical and human capital.

H2: Institutional quality is expected to interplay with firms' features, positively associated with SMEs' TFP. If the complementarity (substitutability) hypothesis holds, institutional quality should be more relevant to firms more (less) capable and operating in more (less) advanced industries, and wealthier (poorer) geographical areas.

Our estimating model is:

$$y_{ij} = \alpha + \beta_1 INST_j + \phi X_{ij} + \epsilon_{ij} \quad (1)$$

where the dependent variable  $y$  is the average TFP (calculated on TFP values from 2010 to 2014) of manufacturing firm  $i$  in region  $j$ ; <sup>1</sup>  $INST$  is either the overall indicator of regional institutional quality  $EQI$  or alternatively the component indexes  $RUL$  or  $GOV$ ; <sup>2</sup>  $X$  is a vector of control variables related to either firms' individual characteristics or regional and sectoral features; and  $\epsilon_{ij}$  is the error term. Firms' individual characteristics included among control variables are:  $SIZE$ , based on total assets;  $AGE$ , in years; a set of dummy variables taking unit value respectively if the firm sets up formal training programs for employees ( $TRAIN$ ), is involved in a foreign business group ( $FOREGROUP$ ), faces competition mainly from rivals located abroad ( $FORECOMP$ ), exports ( $EXP$ ), carries out research and development activities ( $R\&D$ ) and product or process innovation ( $INNO$ ). Regional and sectoral features include: a dummy,  $HMTI$ , taking value 1 for industrial sectors characterized by high and medium-high technological intensity according to the OECD (2011) classification (Hatzichronoglou, 1997); <sup>3</sup> the annual regional growth rate ( $GDP$ ); the regional population density ( $DENS$ ); the regional share of population aged 15-64 with tertiary education ( $EDU$ ); the regional share of households with access to internet at home ( $CONNE$ ); the number of sectors (NACE Rev 2, 2-digit level) in the region with more than 10 firms in 2008 ( $JACOB$ ). A set of industry dummies, controlling for unobserved heterogeneity at the industry level, is also included among regressors. <sup>4</sup> The data appendix provides more details on the variables employed, the sources from which they are drawn, and the heterogeneity in institutional quality and TFP across European regions (see Tables A1 and A2).

To test H1, we estimate our benchmark Equation 1, allowing for random effects at the regional level. To test H2, we first adopt a Quantile Regression, to assess whether the influence of our key variables differs for differently productive firms. Then, we interact institutional variables with firms' characteristics <sup>5</sup>, as the latter ones have been proven to be the most important drivers of

diversity in TFP across European regions (Aiello & Ricotta, 2016). Indeed, in line with this evidence, local institutions can explain a minor share of TFP firm heterogeneity in our work too. Nevertheless, they might play a significant role in either substituting or reinforcing the influence of firms' characteristics positively affecting SMEs' performance. Finally, we make the impact of our main regressors conditional on the type of industry (more or less technologically advanced) the firm belongs to and on the regional GDP per capita growth, regarded as other factors potentially moderating (again either compensating or complementing) institutional effects on TFP.

On a methodological ground, since firms in our sample are nested within administrative regions, we adopt a multilevel (ML) model typically used when dealing with hierarchical data.<sup>6</sup>

It is worth highlighting that the qualitative and quantitative data from the EFIGE survey refer to the triennium 2007-2009 but in most cases are available for 2008 only. As a consequence, we cannot resort to dynamic panel data methods to account for firms' unobserved heterogeneity and potential endogeneity problems, i.e. unobserved cultural and historical factors may drive both TFP levels and institutional quality in a province; more productive firms may choose to operate in areas with better institutional quality, and regions where firms have higher productivity, may aim at changing regulation (Audretsch et al., 2018). Yet, concerns of simultaneity bias are partially attenuated by the fact that a) firm-level data on explanatory variables refer to previous periods (mostly 2008 or 2009) compared to the dependent variable (2010 and 2013 mean value), and b) the key regressors *EQI*, *RUL* and *GOV* are likely to change little and slowly in response to firms' performance.<sup>7</sup> Also, our analysis focuses on SMEs (hiring less than 250 employees), which are likely to be strongly rooted in a region. This makes sensible the conjecture that, while these firms are affected by the institutional quality of the area where are located, it is unlikely that the most productive of them move and sort themselves into provinces with better institutional quality.

Nevertheless, after estimating Equation (1) by the mixed-effects method, we also use a two-stage Instrumental Variables (IV-2SLS) procedure to tackle concerns of residual endogeneity. In

particular, we employ as instruments literacy and urbanisation rates drawn from Tabellini (2010), both defined at the regional level at the end of the 1800s. These rates seem indeed to be good predictors of regional institutions development in the subsequent decades, whereas they can be deemed as exogenous with respect to firms' performance in current years (Tabellini, 2010; Rodriguez-Pose & Di Cataldo, 2015).<sup>8</sup>

## RESULTS

Table 1 reports estimates of equation (1), the key regressor being *EQI*, *RUL* and *GOV*, respectively in columns 1, 2 and 3. A preliminary look at the control variables reveals that they tend to assume the expected sign (except *INNO*) even if in some cases (*FORECOMP*, *EXP*, *R&D* and *INNO*) are statistically insignificant at the 10% or 5% level. Concerning firm-level variables, *SIZE*, *AGE*, *FOREGROUP* and *TRAIN* come out to be relevant. Moreover, a U-shaped relationship emerges between firms' size (total assets) and TFP, and an inverted U-shape relationship between firms' age and TFP. Competing in international markets signals higher abilities and is associated with higher TFP; training has a positive influence on productivity, presumably thanks to the accumulation of employees' skills. Furthermore, little surprisingly, firms operating in the high and medium-high technology industries are on average characterised by better productivity performances. On the other hand, regional variables appear to be not significant in most cases.<sup>9</sup>

### [TABLE 1]

Turning to our key variables, results reported in columns 1-6 clearly indicate that institutions play a role in determining firms' productivity, as coefficients of *EQI*, *RUL* and *GOV* are always positive and highly significant. According to the multilevel estimates, the impact of *RUL* seems slightly higher than that of *GOV*, and in line with that of *EQI*.<sup>10</sup>

To test hypothesis H2, we start by assessing whether the impact of institutions is different for differently productive firms, allowing for different point estimates for firms respectively belonging to the 10<sup>th</sup>, 50<sup>th</sup>, and 90<sup>th</sup> percentile of TFP distribution. Results reported in Table 2 highlight that the impact of the regional institutional quality on TFP is evidently heterogeneous across firms: with some differences among *EQI*, *RUL* and *GOV*, in general the effectiveness of institutional endowment is stronger for the first two considered segments of the TFP distribution, and weaker and statistically insignificant for the last. Therefore, institutions seem to influence firms' performance in a heterogeneous way, benefitting more the less productive firms.

[TABLE 2]

The following analysis extends the latter indication. We introduce an interaction variable *INTE* between the indicator of regional institutional quality and some dummy variables, described in Table A1: *DSIZE*, *DAGE*, *DHK*, *HMTI*, and *DGDP*, taking unit value respectively for firms with at least 50 employees, older than 15 years (first quartile critical value); with a share of graduate employees higher than the national average; operating in high and medium-high technological industries; located in a region with per capita GDP growth higher than the median value.

[TABLE 3]

As shown in the last rows of Table 3, the institutional variables are always jointly significant with the interaction term, the impact of *EQI*, *RUL* and *GOV* being reduced (by the value of the coefficient of *INTE*) for relatively larger and older firms, with a higher share of graduate employees, operating in high and medium-high technology industries.<sup>11</sup> This result implies that the impact is lower for larger and older SMEs (respectively equal to 61.8% and 81.4% of the impact exerted on other firms), and for those with a higher share of graduate employees (88%). Similarly,

the effect of institutions on the productivity of technologically advanced firms is lower, amounting at about 75.6% of the effect exerted on other firms.<sup>12</sup>

Concerning the latter result, an explanation might be in the attitude of high-tech firms to invest in strategic activities such as property right protection to be less exposed to the influence of the external institutional endowment. In this sense, the largest and more powerful high-tech corporations may have a weaker need for effective institutions, since they might even be in the position to shape the institutional action, becoming themselves “institutions of global governance” (May, 2015).

## POLICY IMPLICATIONS AND CONCLUSIONS

The analysis carried out in this work shows that regional institutional quality – meant in both a general fashion, and more specifically in terms of rule of law and government effectiveness – plays a significant role in shaping productivity of European firms, thus extending to the case of SMEs, within a regional perspective, a result common to other previous studies. Our analysis is, to the best of our knowledge, the first empirical exercise aimed at studying interaction effects between local institutional quality and firms’ characteristics. In detail, we aim at detecting which firms benefit more from the context conditions granted by good institutions and find that good institutional quality is more important for SMEs’ performance the smaller and the younger firms are, and the lower human capital and technology they employ.

These results have to be considered with cautiousness and need to be confirmed (or confuted) by future research. It may contain relevant information to policy-makers, as the observed diversity in the impact of institutions on TFP according to the typology of firms has clear implications on long-term strategic plans of the industrial policy, and the choice among “picking the winners” or “building future winners” (Baum & Silverman, 2004; Evenett & Voicu, 2001). An intervention aimed at improving the overall institutional quality is usually interpreted as a horizontal measure,

providing the endowment necessary to allow all firms to count on the same business environment conditions, and therefore equally benefiting the productive system as a whole. Our findings alert instead to the fact that better institutions might especially favour weaker enterprises. Therefore, promoting institutional improvement, *de facto* would translate into an investment for “building future winners”. As a consequence, policy evaluation should be cautious and avoid too negative judgements on measures failing to pick the winners in the short run, but able to support the medium-long term growth of lagging-behind SMEs, and therefore to create the basis for the emergence of future winners.

In conclusion, given the role of institutions for the growth of weaker firms, policies reinforcing the institutional endowment could be considered as policies specifically benefiting specific actors, carried out without paying the potential costs connected to selective policies (Aghion et al., 2011; Birdsall & Fukuyama, 2011; Di Tommaso et al., 2017; Lin, 2011). The regional scope at which our analysis is conducted is particularly relevant because of heterogeneity in European local institutional endowment, and the perspective of EU policies increasingly focused on the regional level, now considered the layer at which policy decisions might have the highest influence (Keating, 1997; Ohmae, 1992).



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<sup>1</sup> As the Data Appendix clarifies, the measure of TFP provided by the EFIGE dataset is defined on a restricted sample. Indeed, AMADEUS balance sheet data, required to compute TFP, are available for around 50% of the EFIGE sample of firms (Altomonte et al., 2012). To verify whether sample selection is an issue, we follow Pellegrino and Zingales's (2017) suggestion, replicating our estimations by omitting those countries (Austria, Germany, Hungary and the UK) that might be under-represented. The outcome of this sensitivity check – focusing on Italy, France and Spain for a total number of 5605 firms, 87% of the estimation sample – corroborates our main findings and is available upon request.

<sup>2</sup> In any case *EQI*, *RUL* and *GOV* are average values of the 2010 and 2013 figures.

<sup>3</sup> High-technology industries are listed in Table A1 note.

<sup>4</sup> Squared terms of *SIZE* and *AGE* are also inserted to account for non-linear effects.

<sup>5</sup> The variables we employ are proxies of size, age and human capital. They are meant to capture, respectively, economies of scale, learning-by-doing effects, and higher capabilities, as well as other potential effects of larger size, longer experience and higher skills on the ability of firms to successfully manage their inputs. For instance, larger and older firms may be less opaque (thus having better access to finance); attract employees with higher skills; may be more export-oriented, and thus more exposed to international competition and beneficial “learning-by-exporting” effects.

<sup>6</sup> This model allows overcoming a restrictive assumption of the traditional single-equation modelling, namely the independence among errors, which entails a higher probability of rejecting the null hypothesis when it is in fact true. For further details on the multilevel approach, see De Leeuw & Meijer (2008).

<sup>7</sup> The kind of institutional facets we consider is likely to fall within the slow-moving category. On slow-moving and fast-moving institutions see, for instance, Roland (2004).

<sup>8</sup> Indeed, human capital accumulation and demographic factors are likely to affect institutional evolution over time. According to Glaeser et al. (2004, p. 272): “educated people are more likely to resolve their differences through negotiation and voting than through violent disputes. Education is needed for courts to operate and to empower citizens to engage with government institutions. Literacy encourages the spread of knowledge about the government’s malfeasance”. Moreover, urbanization could offer higher opportunities for education and foster the development of

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public services (see Turok & McGranahan, 2013, for a critical discussion of the urbanization effects on several channels of economic and institutional development).

<sup>9</sup> Although this result (combined with the following ones on institutional variables) implies that institutions have a stronger impact than the other regional variables considered, we also run a regression (available upon request) on standardized variables, verifying that the *EQI* coefficient is larger than that of all the other variables defined at the regional level.

<sup>10</sup> Since the dependent variable is in log terms, a one-point increase in *RUL* is associated to an 8.8% increase in *TFP*. The Sargan test reported at the bottom of Table 2 confirms the validity of the instruments we employ in columns 3-6. However, the 2SLS coefficients are higher than those obtained in all the other estimations, therefore we focus on the most conservative estimates.

<sup>11</sup> At the bottom of Table 3, the statistical significance of the sums of the key coefficients (*EQI*+*INTE*, *RUL*+*INTE* and *GOV*+*INTE*) is assessed by computing the relative standard errors. This sum tends to be not significant when considering the *DGDP* dummy.

<sup>12</sup> These ratios are obtained as the ratio of the sum of the coefficients of *EQI* and *INTEEQI* over the coefficient of *EQI*, in each case.