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Are institutions in developing countries malleable?

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Abstract

Economists have recently emphasized Solow growth factors, physical capital, labor, and technology (“proximate” causes) depend on fundamentals like geography, culture, and institutions. I consider one of these fundamentals, institutions, and analyze whether they are malleable by a contemporary economic variable, globalization. The globalization I consider is of production through multinational corporations. Using the recently available data on institutional quality for almost all countries, I show institutional quality is higher with a greater FDI presence in developing countries. Nevertheless, there is no statistically significant effect on the same institutional variables in developed countries. By some measures, the income-gap between the rich and poor countries has worsened in the post-1950 period, and a consensus has emerged that poor institutions are to be blamed. A policy of encouraging FDI is likely to have the additional effect of improving institutions in developing countries and may have a greater potential to reduce income gaps than has been realized.

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1. Introduction: The role of institutions and how they may be affected

In the past two decades, economists have distinguished between “proximate” and “fundamental” causes of growth. See, [Rodrik \(2003\)](#). The former includes the traditional factors like physical capital, labor in efficiency units, and technology of the Solow model, while the latter

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stresses that the proximate factors themselves depend on fundamentals like geography, colonial heritage, religious or legal traditions, culture, and institutions. Diamond (1997) is a leading advocate of geography theory of international inequality. By this theory, endowment of natural resources, climate, disease ecology, transport costs, and ease of diffusion of knowledge and technology from more advanced areas are significantly determined by geography. On the other hand, La Porta, Lopez-de-Silanes, Shleifer, & Vishny (1999), Treisman (2000), Swamy, Knack, Lee, & Azfar (2001), and Barro and McCleary (2003) emphasize the fundamentals of religious or legal traditions, colonial heritage, and culture for growth.

North's (1990) contribution emphasizing the role of institutions in economic development is seminal. He defined them as "rules of the game...or...humanly devised constraints...that structure incentives in human exchange, whether political, social, or economic." Rules of the game may either be codified in written laws, regulations, and instructions or they may be cultural traits, unwritten conventions, and practices (Nunn, 2014). In that sense, institutions overlap with cultural and legal traditions. In either case, they affect entry and other costs: The extent depending on their interpretation and effective enforcement and implementation.

Examining the relative roles of geography and institutions (and trade) in determining income levels around the world, Rodrik, Subramanian, & Trebbi (2004) find that the primary role must be ascribed to institutions, viz. "institutions rule." On the other hand, Lucas (1990) finds if the Solow neo-classical determinants are applied to explain, for example, labor productivity differences in the U.S. and India, the marginal product of capital in India must be 58 times that in the U.S. With that difference, investment goods ought to rapidly flow to India and *no* investment should occur in the U.S. Clearly, we need factors other than capital/labor ratio to explain income differences; factors that are captured by the TFP parameter A of the Solow model.

Traditionally, TFP has been narrowly identified with technical efficiency. In the past two decades, there is an increasing realization that social efficiency has a large influence on TFP and performance. For example, using World Bank Enterprise Surveys, 2005–2006 data on 2287 Indian enterprises across 22 industries and 37 Indian cities, Sharma and Mitra (2015) find that complexity in the system (policy or bureaucratic) raises the probability of paying bribes and dampens firm performance; Das (2015) constructs an empirical general equilibrium model and finds that socio-institutional structure plays an important role in assimilating transferred technology, and Sahoo and Dash (2014) demonstrate that India's modern service exports depend more importantly on the quality of institutions and governance (and human capital and telecommunications) than on world demand and real exchange rates.

The above studies take institutions to be exogenous and unvarying. Among factors stressed in the last decades as determining growth, a country's geography and colonial heritage are immutable and its religious traditions are sacrosanct. Similarly, an economy's business-culture, and rules-regulations governing business institutions are slow to change.

This is especially true if the society and economy is closed to outside influences (unless there is an internal revolution that overthrows the old order). In contrast, opening to the outside world may provide the catalyst for internal change in institutions. Under this view, the more globalized, open, and integrated in goods/services and assets trade a country is, the more its institutions are likely to be malleable.

First, consider trade in goods and services. Defining social infrastructure as "institutions and government policies that determine the economic environment within which individuals accumulate skills, and firms accumulate capital and produce output," Hall and Jones (1999) show that tariffs/non-tariff barriers create profitable opportunities for private and government diversion of resources from their efficient uses. Trade openness prevents this diversion and improves

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