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Regulation, trade and economic growth

Magdalene Silberberger[a,*], Jens Königer[b,*]

[a] University of Witten/Herdecke, Faculty of Management and Economics, Alfred-Herrhausen-Straße 50, 58488 Witten, Germany
[b] Gesellschaft für Internationale Zusammenarbeit (GIZ), Berlin, Germany

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ABSTRACT

The role of regulatory quality as one of the so-called deep determinants of growth has emerged as an important issue in economic research in the past 20 years. The positive or negative growth effects of a country's regulatory framework are amplified by economic integration, which makes factors and producers more mobile and enables them to avoid burdensome regulation. Therefore, these two potential determinants of growth might be interlinked. So far there is very little empirical evidence on the impact of the regulatory framework on growth in an integrated economy. We deal with the most common problems in estimating growth equations by using internal instruments to identify a relationship between regulation and growth in the presence of international trade and find evidence that both regulation and trade have a significant positive influence on growth, with the effect of regulation being especially pronounced for countries that have worse regulatory quality and for middle-income countries.

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1. Introduction

In the past 20 years the role of a good regulatory framework for a country's development has been emphasized by policymakers, researchers and international organizations alike. The regulations of a country are part of its economic institutions, which in turn are shaped by the political institutions (Acemoglu and Robinson, 2012). In general, the institutions of a country are defined as the arrangements that structure the political, economic and social interaction among its members. Their main function is to reduce uncertainties that result from incomplete information due to information asymmetries and transaction costs (North, 1990). This facilitates market interaction and improves the functioning of markets in general. In contrast, poorly designed institutions can significantly increase costs and hinder economic activity and specialization (Lee, 2009; Borrmann et al., 2006).

Closely linked to regulation is trade liberalization or economic integration, which can amplify the effects of good or bad regulation. Through increased integration into world markets firms and production factors have become more mobile. Consequently, regulation can become a competitive advantage or disadvantage and can thus either attract firms or become one of the reasons they move into another country with more favorable regulation. Therefore, the growth effect of regulation could depend on the country's level of economic integration.

* Corresponding authors.
E-mail addresses: magdalene.silberberger@uni-wh.de (M. Silberberger), jens.koeniger@giz.de (J. Königer).

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Defining "good" regulation is a difficult task that depends on several factors, e. g. the perspective from which regulation is evaluated. From the public interest perspective, regulation is absolutely necessary to correct for market failures (Pigou, 1938). The main purpose of regulation is to achieve social welfare goals at minimum economic costs. What has to be taken into account, however, is that both the regulators and the regulated generally try to pursue their own interests and that there might also be government failures (Buchanan and Tullock, 1962; Krueger, 1990). Especially developing countries suffer from weak institutional capacity and in the past have mostly failed to deliver regulation that was conductive to development (Jalilian et al., 2007). This gave rise to the idea that regulation might pose an additional distortion and should therefore be reduced. We take on the latter view and assume that there is a positive growth effect through increased productivity of firms and the reduction of production costs. Other possible channels of how a reduction in the regulatory burden might affect growth include increased investment and competitiveness through additional firm entry and the expansion of existing firms.

Despite econometric issues such as data availability and endogeneity, there have been attempts to look at the simultaneous influence of general institutions and trade, in most cases finding joint validity of both (Alcalá and Ciccone, 2004; Dollar and Kraay, 2003a; Rodrik et al., 2004). This view, however, is challenged by Dollar and Kraay (2003b), who argue that the external instruments used in those studies (e.g., historical and geographical factors) have good explanatory power for both the trade and the institutions variable in the first stage and therefore cannot determine the partial effect of trade and institutions on growth. In addition, Acemoglu and Robinson (2012) argue that the political institutions only have an indirect effect on economic growth, namely through their influence on economic institutions. Where political institutions are extractive and lack centralization, there will also be extractive economic institutions that set no incentives and opportunities concerning the participation of individuals and firms in economic life. As a result, there will be little or no economic growth. Regulations, especially business regulations, as part of a country's economic institutions set the rules for firms and thus influence the number of firms in a market, as well as their productivity and competitiveness. If a good regulatory framework allows firms to operate efficiently and improve their productivity, the result will be higher growth. A regulatory framework that distorts the market mechanisms on the other hand will most likely impede economic development.

Due to the lack of suitable data and methodological issues, however, there have been few studies analyzing the effect of (business) regulation on income. Jalilian et al. (2007) investigate the impact of regulatory quality on both a cross-section of 117 countries and a panel of 96 countries from 1980 to 2000 using the World Bank Governance Indicators and government/regulation data from the International Country Risk Guide (ICRG). The authors observe conditional convergence once a variable for government effectiveness or regulatory quality is included, all of which seem to be positively associated with economic growth. In addition, their results suggest that regulation rather than more general governance issues seem to have a larger impact on growth.

Djankov et al. (2006) addressed a similar question using the World Bank's Doing Business database with average annual GDP per capita growth between 1993 and 2002 as the dependent variable and argued that the impact of regulatory quality on GDP growth is very large. Specifically, an improvement from the worst to the best quartile of business regulation is associated with a 2.3 percentage point increase in average annual GDP growth, whereas for example a country's improvement from the worst to the best quartile in primary school enrollment implies an increase in growth by "only" 0.9 percentage points.>

In a similar strand of literature, Easton and Walker (1997),De Haan and Siermann (1998), Carlsson and Lundstöm (2002) and Gwartney et al. (2004), among others, use the Economic Freedom Index (Gwartney et al., 2012) to study the relationship between the broader concept of economic freedom and GDP growth.[1] Their results indicate that economic freedom matters for growth, but that the effect differs depending on the choice of economic freedom measure (Carlsson and Lundstöm, 2002; De Haan and Siermann, 1998).

Finally, a number of studies have examined the effects of regulatory quality in financial, labor or product market regulation on the reallocation of resources, investment and productivity. Most of these studies, however, use very recent data and therefore do not capture long-term effects.[2] The general finding of these studies is that low-quality regulation has adverse effects by increasing the firms' costs, reducing factor accumulation, investment and productivity, distorting the efficient allocation of resources and restricting firm entry and competition among existing firms (Eifert, 2009).[3] Developing countries especially might be prone to problems associated with excessive regulation that was introduced by government officials to increase their rents (Jalilian et al., 2007).

Notwithstanding the relatively convincing results, it is possible that a better regulatory environment does not increase growth in a direct manner, but rather through more trade or intensified global integration of a country.[4] If firm productivity is

[1] For an overview of studies using the Economic Freedom Index see De Haan et al. (2005).

[2] Usually the World Bank Doing Business Indicators (World Bank, 2014a), which are available from 2003, or the World Bank Governance Indicators (Kaufman et al., 2005), available from 1995, are used.

[3] For a good overview on regulation, the allocation of resources and productivity growth, see Arnold et al. (2011). The effect of financial market regulation on economic growth has been of interest from the late 1990s, for example by Rajan and Zingales (1988) and Beck et al. (2005). Recent empirical studies on the effects of product market and labor regulation on economic growth, productivity, investment and innovation include Scarpetta and Tressel (2002), Scarpetta et al. (2002), Nicoletti and Scarpetta (2003), Aghion et al. (2004), Gust and Marquez (2004), Besley and Burgess (2004), Klapper et al. (2004, 2006), Botero et al. (2004), Crafts (2006), Conway et al. (2006), Micco and Pagés (2006), Viviano (2008), Poschke (2010), Bourlès et al. (2010) and Buccirossi et al. (2013).

[4] Integration also includes foreign direct investment. Countries with good regulation could attract more foreign investors, whereas too stringent regulation could push firms to other countries with a lower regulatory burden. We have also tested this hypothesis with similar, albeit less robust, results for trade.

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