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The impact of international trade on institutions and infrastructure

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ABSTRACT

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We develop a theoretical model that explores the impact of international trade on both institutions and infrastructure, while explicitly addressing the correlation between institutional quality and infrastructure investment. We show that trade leads to higher infrastructure investment so that domestic firms become more productive and can, thus, better compete internationally. However, infrastructure investment also has a detrimental effect on firms, as it is financed through firm taxation. As a result, when some firms have stronger political ties than others, trade leads to weaker institutions and more cronyism as the government attempts to lower the tax burden on the politically connected firms. Moreover, we show that trade with a partner characterized by high aggregate firm productivity or low firm fixed costs induces a country to invest more heavily in both its infrastructure and its institutional framework. *Journal of Comparative Economics* **41** (1) (2013) 126–140. Rutgers, The State University of New Jersey, New Brunswick, NJ 08901, USA; NOVA School of Business and Economics, Lisbon 1099-032, Portugal; University of California at Berkeley, Berkeley, CA 94702, USA.
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1. Introduction

Crony capitalism is prevalent in many developing countries, where firms with close ties to the government receive favors of significant economic value. Such preferential treatment includes tax breaks, investment credits, subsidies, subsidized loans, or relaxed regulatory oversight by the authorities. For example, Sorj (1998, p. 28) argues that Brazil's state land policies have been traditionally characterized by the following pattern: "The state takes responsibility for the onus, the bonus is distributed among the dominant classes, and the crumbs are left over for the subaltern groups".[2] In Indonesia, during Suharto's 32-year rule, there was well-documented deep-seated cronyism and nepotism; as a result, firms connected to the Suharto family experienced a negative shock to their stock values once rumors started circulating that Suharto was facing serious health

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[1] A member of the Giannini Foundation for Agricultural Economics.
[2] As translated and quoted by Pereira (2003, p. 42). Pereira actually argues that the recent comprehensive agrarian reform of the Cardoso government (1995–2002) was characterized by a similar pattern, as it disproportionately benefitted a small number of politically powerful, large producers.

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problems (Fisman, 2001).[3] South Korea is another such example of an Asian economy with a high degree of cronyism. Since its independence in 1948, it has seen a seemingly endless flow of corruption scandals bring down scores of its elites, including members of many presidential staffs, numerous military officers, politicians, bureaucrats, bankers, businessmen, and tax collectors (Kang, 2002). Moreover, in Russia in the 1990s, as the economy was integrating into the world economy, there is evidence that politically strong governors were successfully assisting (some) enterprises in their regions to avoid paying federal taxes (Ponomareva and Zhuravskaya, 2004).

According to existing theory, cronyism tends to be more pervasive in the presence of high rents, as the latter create contests for their capture by the different elite groups, resulting in severe distortions in the economy (e.g., Auty, 2007). At the same time, international trade is often proposed as a remedy for improving economic and political institutions (e.g., IMF, 2005; Johnson et al., 2010), and thus reducing cronyism. However, opening an economy to trade could result in precisely such high rents. A question that then naturally arises is whether international trade is in fact the appropriate remedy for cronyism. In this paper, we propose a novel mechanism explaining how international trade could lead to more cronyism, although it still results in overall welfare gains for the economy. The key point is that the government can use public investment to increase the international competitiveness and thus the profitability of domestic firms (e.g., by investing in trade-related infrastructure). We then argue that in the presence of politically connected firms, the ability of the government to implement such policies might lead, under trade, to a deterioration of the institutions in place.

More specifically, we model an economy, where consumer preferences are characterized by love for variety. Furthermore, we assume that some firms have political connections to the government, allowing them to receive preferential tax treatment (e.g., allowing them to secure larger tax breaks or evade their tax obligations more extensively than nonconnected firms). The government performs two main tasks in this economy: It carries out infrastructure investment and determines the quality of institutions, financing both through firm taxation. The former task has important ramifications for the production side of the economy, as it affects firms' productivity, and thus their ability to compete against foreign firms both domestically and abroad. The latter task has a significant impact on the distribution of the tax burden among firms. The reason is that stronger institutions mitigate the importance of political connections, leading to a more equal tax treatment across firms. On the other hand, weaker institutions enable politically connected firms to better exploit their connections in order to receive preferential tax treatment at the nonconnected firms' expense.

We find that in equilibrium only the firms that are relatively politically connected find it optimal to engage in production. Furthermore, under trade, only the most connected of them export.[4] We then show numerically that for plausible parameter values, trade results in political favoritism permeating the economy further in comparison with autarky. Intuitively, once the economy opens up to trade, the government has a strong incentive to invest in (trade-related) infrastructure, so that firms' productivity and thus their international competitiveness increase. However, greater infrastructure investment implies a higher firm tax burden. Therefore, the government caring about the politically connected firms, ''compensates'' them by distorting institutions in their favor so that they receive a more favorable tax treatment. In other words, our findings illustrate that in the presence of politically connected firms, international trade is not a remedy for weak institutions, as an open economy ends up with more cronyism than a closed one (but it still attains higher national welfare). At a more general level, our results suggest that a reform involving extensive trade liberalization might give rise to an oligarchic regime.

Another important finding that emerges from our analysis is that the domestic economy's equilibrium policies under trade are a function of its trading partner's characteristics. In particular, the higher the aggregate firm productivity or the lower the firm fixed costs in the trading partner, the higher the infrastructure investment and the institutional quality in equilibrium domestically. Institutional quality rises in this case because the government needs a larger tax base in order to finance the higher spending on domestic infrastructure.

Historically there are many instances, where international trade has gone hand in hand with cronyism and weak institutions in general. In the 1700s, for example, the economies of the Caribbean concurrently experienced substantial trade growth, the proliferation of slavery, and the emergence of oligarchic societies (Rogoziński, 1999; Engerman and Sokoloff, 2002). Another example is Germany and other European states in the 16th and early 17th century, where high economic and trade growth coincided with elevated taxation and the redistribution of resources to favored groups in the economy (Ogilvie, 1992). Our main prediction, therefore, is consistent at a broad level with a number of historical experiences.

Our paper relates to a broad literature on international trade, infrastructure, and institutions. One strand of this literature addresses the effect of various aspects of institutional quality on trade flows. Specifically, Anderson and Marcouiller (2002) employ different measures of (in)security in international exchange in their analysis, Ranjan and Lee (2007) look at the quality of contract enforcement, whereas Dutt and Traca (2010) focus on corruption. Furthermore, Berkowitz et al. (2006) analyze how both exporter and importer institutions influence trade in simple and complex product markets, Levchenko (2007) explores whether countries with higher quality of contract enforcement and property rights capture higher US import shares in more institutionally dependent sectors (as proxied by measures of product complexity based on intermediate good use), while Nunn (2007) examines how contract enforcement affects comparative advantage through underinvestment in relationship-specific investments. A second strand investigates the impact of infrastructure on international trade, including

[3] A similar phenomenon was observed in Malaysia immediately following the Asian financial crisis of 1997, whose initial impact was to reduce the expected value of government subsidies to politically favored firms (Johnson and Mitton, 2003).

[4] This result is consistent, at a broad level, with the findings of a number of empirical studies that show that political connectedness and firm size are strongly and positively correlated (e.g., Agrawal and Knoeber, 2001; Johnson and Mitton, 2003; Faccio, 2006).

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