



Unbundling institutions for external finance: Worldwide firm-level evidence☆

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ABSTRACT

The literature on institutions has been challenged on grounds of reverse causality, measurement error in institutional indicators, and heterogeneity. This paper uses firm-level data across countries to confront these challenges. We focus on the effect on firm-level external finance, and “unbundle” institutions in the sense of Acemoglu and Johnson (2005), while addressing the largely-ignored issue of measurement error in institutional indicators. We find that contracting institutions that facilitate transactions between private parties exert little effect on firms' access to external finance. In contrast, property rights institutions that constrain political and economic elites exhibit a strong positive association with access to external finance. Interestingly, the association between property rights institutions and external finance tends to be stronger for working capital than for investment. Our results suggest that an important channel for institutions and especially property right institutions to affect development is through access to external finance.

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1. Introduction

A large literature has emerged in the past few decades emphasizing the fundamental importance of institutions in explaining economic development. This literature, starting with North and Thomas (1973) and North (1981, 1990), was revived by the growing availability of country-level indicators of institutions (Knack and Keefer, 1995; Mauro, 1995; La Porta et al., 1998; Rodrik et al., 2004), and reinvigorated by recent work that linked country-level development with early endowment and colonial experience (Sokoloff and Engerman, 2000; Acemoglu et al., 2001, 2002). The bulk of this literature concludes that institutions are fundamental causes of long-term growth. Particularly influential among these studies is Acemoglu et al. (2001) (AJR (2001) hereafter), who use settler mortality in early colonial periods as instruments for current measures of institutions, which in turn determines the current development level. The authors find strong effects of institutions on current development.

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This literature, however, also faces strong challenges. One challenge is whether one can claim causality from institutions to development. For instance, Glaeser et al. (2004) disagree with the interpretation of AJR (2001) that they have demonstrated the fundamental importance of institutions for long-term growth. Glaeser et al. (2004) argue that the institutions-development regressions are plagued by reverse causality. Namely, when countries get richer and their populations become more educated, institutions improve, producing a spurious positive correlation between institutions and development. Settler mortality, they argue, is not a good instrument for institutions because the ratio of colonists to the indigenous people (implicit in the settler mortality measure) is also strongly correlated with human capital: colonists brought with them not only better institutions but also human capital and know-how. Because human capital is omitted from the outcome regression, settler mortality is not a valid instrument. They also provide explicit evidence consistent with this challenge.

A second, less-noted challenge facing the empirical literature on institutions is that it is unclear whether results on the relationship between institutions and development are comparable across studies. It is hard to pin down institutions precisely. The most famous definition is from North (1990, p. 3), who defines institutions as “the rules of the game in a society or, more formally...the humanly devised constraints that shape human interaction.” With such a broad definition, it is not surprising that researchers have used different measures of institutions, and that they often reach different conclusions on their importance or lack thereof.¹

Some studies rely on comprehensive and aggregate measures of institutions: Rodrik et al. (2004) use the Kaufman et al. (2002) “Rule of Law” index, a composite indicator of numerous variables from various sources measuring different aspects of the protection of property rights and strength of legal and judicial systems. Knack and Keefer (1995) use an index of several indicators (including one on risk of government expropriation) from the International Country Risk Guide (ICRG). Others rely on more specific aspects of institutions: Mauro (1995) and Li et al. (2000) use a corruption indicator from Business International, while AJR (2001) use the ICRG expropriation risk measure and an index of executive constraints from Polity IV.

Other authors prefer more *de jure* or objective measures of institutions. For instance, Glaeser et al. (2004) argue that most indices of institutions used in the literature are outcomes of institutions rather than objective measures of institutions, which, in their view, should be durable and rule-based. Thus they prefer *de jure* measures of institutions such as differences in electoral laws (proportional representation vs. majoritarian elections) and judicial independence. But this approach also suffers from the omission of a key component, enforcement (Woodruff, 2006).² The World Bank’s “Doing Business” project developed a series of objective measures on strength of legal rights for borrowers and lenders, minority shareholder protection, and other issues.³ Again, they are not without their problems, such as the omission of enforcement quality, so there are some anomalous rankings. For example, on strength of legal rights for borrowers and lenders, Vietnam scores better than France and Germany (Woodruff, 2006), and it is unclear whether and to what extent these measures—often asked about a very specific procedure or type of firm—are relevant to the experience of different types of firms and people. Furthermore, even with the same underlying theoretical construct, different measures are often constructed using different methods, with varying degrees of measurement error, which can result in significant biases in their estimated effects. Thus, an important, though often ignored, issue for the literature of institutions and development is measurement error in institutional indicators.

More importantly, different measures of institutions may very well reflect distinct theoretical constructs, with some mattering more than others for development outcomes. This point is forcefully expressed in Acemoglu and Johnson (2005) (AJ (2005) hereafter), who unbundle institutions into two types: contracting institutions and property rights institutions. Contracting institutions refer to those that “enable private contracts between citizens”, while property rights institutions refer to those that “protect citizens against expropriation by the government and powerful elites.” They argue that government officials, and to a lesser extent, economic elites, can use force or other resources to back up their demands and therefore pose real dangers. In contrast, when contracting institutions increase the costs of doing business in some way, contracting parties may use alternative ways of transacting. For example, instead of using bank finance, firms may resort to reputation-based financing such as trade credit. While AJ (2005) make an invaluable theoretical contribution to the literature, their empirical tests are not without problems. They use legal origin variables as instruments for contracting institutions, and settler mortality as the instrument for property rights institutions. But they may be invalid instruments (Glaeser et al., 2004; Morck and Yeung, 2011; Bazzi and Clemens, 2013) if they are correlated with other determinants of development such as human capital, infrastructure, and other aspects of institutions. Without convincingly valid instruments, the potential for reverse causality remains (Glaeser et al., 2004).

In this paper, we follow AJ (2005) by investigating how contracting institutions and property rights institutions affect a key development channel: external finance. We differ from the literature in relying on firm-level micro data. An advantage of our empirical design is that there is less potential for reverse causality. While it is plausible that the level of development (as measured by GDP per capita, for example) would affect institutions, it is less likely that firm-level access to external finance would affect institutions, especially in the short run. Although we still cannot completely rule out omitted variable bias, from some third variable correlated with institutions and access to finance, this research design improves the credibility of the estimates on the impact of institutional variables. We choose external finance as our dependent variable because it is well-established that access to external finance is a key channel through which development occurs. For instance, cross-country empirical studies have shown

¹ See Woodruff (2006) for a survey of corruption measurement.

² Peru, for instance, receives a perfect seven based on judicial independence from La Porta et al. (2004), which is based on objective measures of institutions. Yet, “Peru’s judicial opinions were available for purchase, the sales agent was Fujimori’s right hand man” (McMillan and Zoido, 2004; Woodruff, 2006).

³ See <http://www.doingbusiness.org/methodology>.

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