Trade Liberalization and Institutional Reform*

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Abstract
Opening up to global trade and investment is often thought to trigger institutional improvement by raising the expected benefits of institutional reform and reducing incumbents’ incentives and ability to preserve the status quo. However, recent experience is not entirely consistent with this conventional wisdom. We suggest an explanation based on variation across countries in firms’ reliance on ambient institutions. Large, well-established firms depend less on an economy’s institutions than do small and incipient firms. Multinational firms likewise can use their global organizations to sidestep weak local institutions. Firm heterogeneity of this sort can thus contribute to markedly different institutional responses to liberalization—institutional development is better in locations where firms and potential entrants benefit more from such development. Our framework also suggests that institutional development might occur in stages. In an economy whose basic institutions are sound, individuals rationally invest in entrepreneurial capability and firms rationally invest less in institution substitutes. Economies with firms that rely more on ambient institutions or with more potential entrants who would rely on those institutions are more likely to experience further institutional improvement following accession to the global economy. Economies with fewer firms or potential entrants dependent on sound institutions, in acceding to the global economy, may exhibit scant institutional improvement, and perhaps even institutional deterioration. Political rent-seeking is not necessary for the latter outcome, but expands the range of conditions under which it ensues.

1. Introduction

Much recent work highlights the importance of “sound institutions” in promoting efficient resource allocation. The

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term “institutions” refers to the legal, regulatory, and social constraints that lower information costs, check opportunistic or agency behavior, and thus permit long-term contracts between strangers. This reduces the general costs of doing business, enhances the efficiency of resource allocation (Beck and Levine 2005), lowers entry barriers (Djankov et al. 2002), and strengthens an economy’s performance (Acemoglu, Johnson, and Robinson 2005a).

However, institutions are path-dependent and change slowly, partly because the status quo often suits established firms and their principals (Morck, Yeung, and Yu 2000; Rajan and Zingales 2003). This path dependence may result in a socially undesirable, but stable political economy equilibrium (e.g., Acemoglu, Johnson, and Robinson 2005a; Morck, Wolfenzon, and Yeung 2005).

Indeed, recent work, surveyed in Morck, Wolfenzon, and Yeung (2005), sees political rent-seeking (corruption) as a key barrier to institutional development (Morck, Stangeland, and Yeung 2000; Rajan and Zingales 2003). However, others, notably Sachs (2005), suggest that corruption is overemphasized as a barrier to institutional development. Although we regard political rent-seeking as important, we concede the value of exploring other possible barriers to institutional improvement.

We therefore offer an explanation unrelated to rent-seeking for the mixed relationship observed between openness and institutional development. We let the level of institutional improvement be set by a benevolent, though myopic, government. Myopia is plausible given the political economy literature relating government policies to short-term election cycles. In dictatorships, especially in ethnically fractionalized countries, the omnipresent threats of coups d’état, rebellion, and regional warlords can induce a similar myopia (Easterly and Levine 1997).

Recognizing that institutional improvement raises a government’s regulatory and enforcement costs, political leaders improve institutions only if the near-term expected benefit outweighs the near-term expected cost. The marginal benefit of institutional development depends on characteristics of the corporate sector—

Khanna, Jeff Nugent, Felix Oberholzer-Gee, Florencio López de Silanes, Ugo Pagano, Dennis Mueller, Enrico Perotti, Ramkishen Rajan, Ken Shotts, Jordan Siegel, Daniel Wolfenzon, and seminar participants at the Asian Economic Panel meeting; the Aspen–Ford Foundation Stern 2004 Global Scholar Network Conference; the 2005 Business and the Social Environment Conference in Evanston, IL; and the City University of Hong Kong, Guanghua School of Management Peking University, National Singapore University Business School, University of Southern California, and Yuen Zhe University Business School. All errors are our responsibility. Partial funding from the SSHRC and the Ford Foundation is gratefully acknowledged.
specifically, the importance of local institutional development and the proportion of firms that rely on sound institutions.

Institutional development reduces the cost of doing business (La Porta et al. 1998) and promotes entrepreneurial entry (Djankov et al. 2002), but the benefits vary across firms. Unlike independent firms, business groups may provide a substitute for weak institutions (Khanna and Palepu 2000). A business family in a developing economy quite often controls many firms, each operating in a different industry. The firms in such business groups can contract with each other reliably and cheaply because they are governed by a single party, the patriarch of the business family. Business families also can invest in relationships with each other, with bankers, and with government officials, again to circumvent weak institutions. These ties can be seen as blurring the boundaries of the business group by extending relationships beyond firms over which a business family has direct equity voting control.

Once these investments are in place, business groups are relatively independent of their countries’ weak institutions, and therefore benefit little from institutional development.

On the other hand, small businesses are much more dependent to their institutional environment. Bhidé (2008) depicts how Bangalore entrepreneurs allocate capital inefficiently and profit only marginally because they lack social trust, property rights protection, and an effective court system to enforce contracts, and thus are unable to carry out fair market transactions with arm’s-length financiers, suppliers, and employees. Bhidé shows that high-growth firms in Bangalore are indeed laggards by U.S. standards and argues that the most needed improvements are of “basic” government functions, such as better legal codes defining land ownership, better property rights enforcement, and more efficient provision of infrastructure (roads, electricity), land record keeping, and tax collection.

The overall benefits of institutional development are thus greater in countries whose established firms have invested less in substitutes for good institutions, and in countries with longer queues of potential entrants, who also lack such investments. We call the benefit of institutional improvement to institution-dependent existing firms the external reliance effect; that to potential entrants we call the entry push effect. We develop a simple closed economy model to show how the equilibrium level of institutional development depends on both effects. The implication is that institutional development exhibits path dependence and thus is divergent across countries.

Some proponents of globalization argue that liberalization disrupts such undesirable equilibria, and so permits institutional reforms capable of supporting more so-
cially desirable equilibriums (Rajan and Zingales 2003; Bhagwati 2004; Morck, Wolfenzon, and Yeung 2005). Caves (1974) argues that inward foreign direct investment (FDI) accelerates growth because, among other things, it reduces entrenched firms’ market power and improves resource allocation. Sachs and Warner (1995, p. 3) write: “As Smith’s followers have stressed for generations, trade promotes growth through . . . heightened domestic competition as a result of international competition.” The gist of all these arguments is that globalization reduces incumbents’ abilities and incentives to preserve the status quo. In addition, financial market liberalization may induce capital flight; the threat of capital flight in turn limits rent-seeking by political agents and insiders, and so improves institutions.

From the perspective of economic growth, liberalization broadens and raises the benefits of institutional development and thus increases its likelihood of occurring. Although engagement with the global economy clearly fuels growth in many economies (Sachs and Warner 1995), post-liberalization institutional development, however, is most evident only where combined with complementary reforms in education, regulatory environment, and other institutions (Bolaky and Freund 2004).

Openness, generally, is no guarantee of institutional improvement. For example, Turkey opened substantially between 1995 and 2003, yet posted a falling “economic freedom score,” a widely used measure of institutional development. This case is by no means unique. Bekaert, Harvey, and Lundblad (2005) show growth responding to equity market liberalization differing across countries and largest in countries with the highest initial institutional quality. This belies a simple positive relationship between openness and institutional development.

Using our framework developed for a closed economy, we explain the mixed relationship by modeling the growth impact of opening a closed economy as depending on the extent to which institutional reform benefits existing firms (our external reliance effect) and potential entrants (our entry push effect).

We then extend our analysis beyond a benevolent government to show how political rent-seeking shifts the balance further, making liberalization even less likely to presage institutional improvement. If established firms capture rents that dissipate slowly (Leuz and Oberholzer-Gee 2006; Siegel 2007), they lobby politicians for weak institutions. If they depend little on domestic institutions, weak institutions that deter domestic entry could even help them survive global competition.

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Several insights emerge from this exercise:

First, institutional development occurs in stages. A threshold level of institutional development—perhaps encompassing universal public education, good government, and the rule of law—is necessary to deter established firms from investing extensively in substitutes for sound institutions. These institutions also plausibly give people opportunities and incentives to invest their time and effort in developing entrepreneurial skills. Once this first tier of institutions is in place for a time, trade liberalization is more likely to instill further institutional development of the sort that promotes faster corporate growth and a higher pace of entry and hence faster overall economic growth.

Second, path dependence and divergent institutional development across countries can occur absent rent-seeking. In an economy whose initial basic institutions are weaker, firms invest more in substitutes for those institutions, and latent entrepreneurs form a shorter queue. Both effects reduce the near-term benefits of institutional improvement, so even a benevolent government, if it discounts the distant future sufficiently, sees little point in costly institutional reforms. As subsequent governments reach the same conclusions, institutional development stalls. In our model, small differences in institutional initial conditions can induce widely divergent institutional development.

Finally, an economy’s response to trade liberalization depends on its initial level of institutional development. We model liberalization as a shock that can change both incumbents’ preferences regarding institutions and the queue of potential entrants. Hence, liberalization induces the government to re-evaluate the costs and benefits of institutional change. Whether or not liberalization portends institutional improvement, therefore, is closely related to the actual and potential composition of the corporate sector. This, in turn, depends on extant basic institutions: A certain level of institutional development is necessary before openness presages further institutional development.

The rest of the paper is organized as follows. Section 2 describes our intuition and illustrates it with country examples. Section 3 sets up the model, and establishes decision rules in a closed economy. Section 4 introduces global competition and examines its impact on the domestic equilibrium. Section 5 extends the analysis to a rent-seeking framework and discuss policy implications. Section 6 presents our conclusions.
2. Setting the stage

We follow North (1990, p. 3) in defining institutions as “the rules of the game in a society or, more formally . . . the humanly devised constraints that shape human interaction.” Sound institutions are constraints that facilitate contractual exchanges of goods and services across distances and over time, usually by strengthening the contracting parties’ private property rights. Specifically, sound institutions alleviate information asymmetries, agency problems, and opportunism that involve either the other contracting party or government officials. In that sense, institutions render contracts more certain and cheaply enforceable, and so reduce the general cost of doing business.

Much recent work casts light on which institutions are most important to sustained economic growth. Mankiw (1995) and De Soto (1989) show that certain basic institutions—an efficient judiciary, a general respect for the rule of law, education, and well-protected basic private property rights—are essential precursors to development.

Rajan and Zingales (2003) show that financial institutions, such as efficient banking systems and stock markets, are also important for sustained growth. However, well-developed financial institutions seem contingent on efficient courts, the rule of law, and private property rights (La Porta et al. 1997, 1998; Morck, Yeung, and Yu 2000; Durnev, Morck, and Yeung 2004). In addition, efficient capital allocation is known to depend on other institutional factors that keep corporate governance from becoming overly entrusted to tiny elites, and that induce broad public participation in capital markets (Morck, Stangeland, and Yeung 2000). La Porta, Lopez-de-Salinas, and Shleifer (1999) show dispersed share ownership to be contingent on these same basic institutions—well-run courts, the rule of law, and property rights.

2.1 External reliance effect

Deficiency in such basic institutions induces firms to invest in substitutes for those institutions, business group affiliations, political connections, and the like. This makes them relatively institution-independent (less affected by their economy’s poor institutions). Khanna and Palepu (2000) argue that business group ties circumvent dysfunctional institutions, especially markets.

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2 Greif (1993) demonstrates the importance of unofficial institutions, like ambient ethical systems. However, more formal institutions, like laws, regulations, and enforcement mechanisms, are arguably more influenced by political decisions, and thus more pertinent to our analysis.
Intuitively, information asymmetries, agency problems, and opportunism are reduced if a firm does business with another also controlled by the same family. In a similar vein, Zhao (2006) argues that sophisticated firms with multiple units can use their internal coordination skills and organizational complexity to shield their intellectual property from leakage, even if the external environment does not respect intellectual property rights. Leuz and Oberholzer-Gee (2006) argue that firms invest in ties with financial institutions to reduce their costs of capital. Additionally, the business families who control large corporate groups invest in political connections, which appear more valuable in economies with weaker institutions (Faccio 2006).

We collectively label these factors the economy’s external reliance effect. The more its established firms rely on the economy’s institutions, the more upside its political leaders see in strong institutions.

2.2 Entry push effect
Weak institutions not only induce existing firms to invest in substitutes for institutions, they also discourage entrepreneurship, and thus entry. Weak institutions impede the development of capital markets (La Porta et al. 1998; Rajan and Zingales 2003) and thus increase entrepreneurs’ costs of borrowing or issuing shares to capitalize their new firms. Ineffective legal systems and weak private property rights expose entrepreneurs to predation by corrupt officials or established businesses, and further shrink their expected returns (Djankov et al. 2002). To the extent that weak institutions make rent-seeking more profitable than innovation, they divert talented people into government and away from entrepreneurship (Baumol 1990; Murphy, Shleifer, and Vishny 1991).

We label this set of factors the economy’s entry push effect. The more prospective entrepreneurs the economy has waiting in the wings, the more upside its political leaders see in strong institutions that facilitate their entry.

2.3 Costs and benefits of institutional development
Rules and regulations are costly. Designing and enforcing them costs the government money; complying with them costs businesses money. The institutions of a developed economy require governments and businesses to hire people with accounting, financial, legal, information management, and technological expertise, and the education system to train them. Strong institutions are only worthwhile if enough firms benefit from them.

With a preponderance of institution-independent firms present, marginal institutional improvement could reduce welfare. This logic can be pressed further: en-
trenched insiders, who benefit from weak institutions that deter entry, might even actively oppose strong institutions (Rajan and Zingales 2003; Morck, Wolfenzon, and Yeung 2005). Consistent with this, Braun and Raddatz (2008) find that established firms are more likely to oppose financial development if potential competition poses an immediate threat to their profitability. These incumbent firms appear to regard financial underdevelopment as a way to protect their rents.

2.4 Trade liberalization and institutional reform

Trade liberalization is an especially interesting event in this context because Rajan and Zingales (2003) and Bekaert et al. (2007) present highly coherent arguments that it raises the net benefit of financial development. Levchenko (2007) models institutional quality differences across countries determining their comparative advantages in trade. Wei (2000) finds a positive correlation between openness and institutional quality, and links this to global competition rendering inefficient institutions unsustainable.

These relationships are statistically significant (Rodrik, Subramanian, and Trebbi 2004), but the data show substantial variation around this effect: quite a number of countries lie quite far away from the general pattern in the data (Stefanadis 2007).

We propose that increased openness does correlate with strengthened institutions, but only if the necessary institutional precursors are already in place. Specifically, we propose a path dependence determined by the actual and potential composition of a country’s business sector. If many existing firms in a country’s large corporate sector and/or a long queue of potential entrants all stand ready to benefit from institutional improvement, trade liberalization is likely to spur institutional improvement. If many existing firms in a country’s large corporate sector have made investments that render them largely independent of the country’s institutions and/or the queue of potential entrants is short, trade liberalization is unlikely to trigger institutional reform.

These differences in the composition of the current and potential corporate sector are related intimately to the quality of the country’s initial institutional environment. We propose that this reflects a profound path dependence in institutional development: a slightly better initial institutional environment can lead to a larger incidence of institution-independent firms and a longer lineup of aspiring entrants, which justify further institutional development upon trade liberalization. Institutional development can thus diverge across countries experiencing similar shocks.
The next sections illustrate these interactions with a simple general equilibrium model.

3. Basic model

This section presents a closed economy model that captures the variation in firms’ dependence on external institutions and how this alters policy choices. It lays out the key parameters and sets the stage for our discussion on the impact of increased openness (in section 4), and for an extension of the model to encompass rent-seeking (section 5). The model is kept deliberately as simple as possible to focus on the essentials.

3.1 Institutional development

We assume the conventional demand function \( D = D(p) \), with \( D'(p) < 0 \), by a fixed population of consumers. Below, we let \( D(p) = a - b \cdot p \) for algebraic convenience, but any function decreasing in \( p \) should generate similar results. Firms meet demand by investing in production until their marginal cost equals the price of their output.

Firms’ costs depend on the institutional environment, which encompasses all manner of institutions, from the provision of basic infrastructure and property rights protection to sophisticated rules and regulations for financial development and innovation. We use an indicator of institutional deficiency, \( \lambda \leq 1 \), with a higher \( \lambda \) implying higher costs of doing arm’s-length business. These costs of weak institutions are assumed deadweight losses.

Firms can reduce their dependence on weak institutions by investing in substitutes for them. We gauge each firm’s institutional independence by \( z \in [0,1] \), where the fraction \( z \) of its operations is independent of external institutions. Thus, the firm’s cost function is

\[
c(z,\lambda) = zc + (1 - z)\lambda c. 
\]

(1)

A “high \( z \)” firm is little affected by domestic institutions, whereas a “low \( z \)” firm’s costs are elevated substantially if domestic institutions are weak. We assume the \( z \), including those of potential entrants, to be continuously distributed on the unit interval. The mass of type \( z \) firms is \( f(z) \).

We assume constant returns to scale, so \( f(z) \) can represent one or many firms of the same type \( z \). We therefore refer to \( f(z) \) as the incidence of firms with institutional in-
dependence $z$. Note that $f$ is treated as exogenous at any given point in time. However, it could readily be considered an equilibrium outcome of a firm’s decision to invest in substitutes for weak institutions in previous periods. For example, if firms in an adverse institutional environment find business group ties more useful, they invest in these ties and $f(z)$ shifts to the right. This partly explains why business groups are more prevalent in economies with weaker legal institutions (La Porta et al. 1998).

In a real economy, other factors also might come into play. For example, $\lambda$ and $f(z)$ might vary endogenously across industries. Economies concentrated in mining or agriculture versus export-oriented manufacturing might develop different institutions. Firms in more capital-intensive industries might find institution-circumventing capabilities more valuable, leading to a higher incidence of “high $z$” firms in those sectors. Firms in more highly regulated industries, such as energy and telecommunications, might be in similar positions.

To keep the model simple, we abstract away from the industry specifics at this stage and focus on the firm distribution at the aggregate level. We will get back to the implications of cross-industry variations when we discuss the policy choices upon trade liberalization.

### 3.2 Equilibrium

Aggregate supply at price $p$ depends on the incidence of firms able to supply at cost $p$. As $p$ rises, additional institution-dependent firms (those with lower $z$) enter. The marginal firm has $z = z_0$ such that

$$c(z_0, \lambda) = c \cdot [z_0 + (1 - z_0)\lambda] = p$$

Given the distribution of firms’ institution-dependence, the aggregate supply function is $Y = \int_{z_0(\lambda)}^{1} f(z)dz$, which is a function of the economy’s institutional development level, $\lambda$.

As institutions improve ($\lambda$ falls toward 1), costs fall for all firms with $z < 1$ and the aggregate supply curve shifts to the right. Firms also become less heterogeneous, for

$$c[z_0 + (1 - z_0)\lambda] \rightarrow c$$

as $\lambda \rightarrow 1$ for all firms regardless of their $z$. That is, improved institutions render institution-dependent and institution-independent firms more alike. Moreover, if the incidence of firms with institution-dependence $z, f(z)$, is higher over a certain range of $z$, the
aggregate supply curve is more elastic (flatter) in that region. This is because a small increase in $p$ induces more entry, and hence increases aggregate supply more sharply.\footnote{At equilibrium, the slope of the supply curve is $\frac{\partial p}{\partial Y} = \frac{\partial p}{\partial z_0} \cdot \frac{\partial z_0}{\partial Y} = -\frac{c \cdot (1 - \lambda)}{f(z_0)} > 0$.}

At equilibrium, supply equals demand:

$$p = c \cdot [z_0 + (1 - z_0)\lambda] \quad \text{and} \quad D(p) = \int_{z_0}^{1} f(z)dz$$

(2)

Therefore, $D(c \cdot [z_0 + (1 - z_0)\lambda]) = \int_{z_0}^{1} f(z)dz$. Partially differentiating this with respect to $\lambda$ implies

$$D'(p) \cdot \left[ (1 - z_0) + (1 - \lambda) \frac{\partial z_0}{\partial \lambda} \right] = -f(z_0) \frac{\partial z_0}{\partial \lambda}$$

(3)

The right-hand side of equation (3) illustrates that a worsened institutional environment, $\partial \lambda > 0$, drives out more institution-dependent firms and reduces output. The left-hand side indicates that a marginal deterioration in the institutional environment corresponds to the marginal firm’s production cost being higher by $c(1 - z_0) > 0$, requiring it to be less dependent on institutions, with $\partial z_0/\partial \lambda > 0$. The net impact on price and output is determined by the adjustment in the equilibrium.

By assuming $D(p) = a - b \cdot p$, we can make this mechanism more concrete; for then

$$\frac{\partial z_0}{\partial \lambda} = \frac{bc(1 - z_0)}{f(z_0) + bc(\lambda - 1)} > 0$$

(4)

A marginal deterioration in ambient institutions reduces supply by

$$\frac{\partial Y}{\partial \lambda} = \frac{\partial}{\partial \lambda} \int_{z_0}^{1} f(z)dz = -f(z_0) \frac{\partial z_0}{\partial \lambda} = \frac{1 - z_0}{1 / bc + (\lambda - 1) / f(z_0)} < 0$$

(5)

This, in turn, implies a new equilibrium with higher prices and lower output.

### 3.3 The evolution of policy

In each period, the government inherits an economy with a predetermined level of institutional development, and considers revising $\lambda$ to maximize social welfare in the next period, which we assume equivalent to maximizing the total output $Y$. Note that we could explicitly model social welfare as the sum of producer and consumer surplus. Doing that introduces more algebraic notation but does not qualitatively affect our analytical results, as long as social welfare is monotonically increasing in total corporate sector output.
We assume that the government considers continuous paths of institutional improvement toward temporally local social welfare optima. That is, we do not let the government optimize across all levels of institutional development. For example, we do not let Rwanda simply abandon all its own institutions and adopt Danish ones at the outset. Nor do we have the Rwandan government maximize a present discounted value of all future social welfare and choose an optimal development path through all time at the outset.

This approach is warranted for several reasons. First, governments may not be able to pre-commit to any long-term path of institutional development. Parliament cannot pass a law limiting its power (Kydland and Prescott 1977), and absolute monarchs and dictators have even worse problems in switching policies over time. Moreover, democratic governments are constrained by election cycles, and this can give rise to myopic policies in a variety of ways (see, e.g., Nordhaus 1975 and Rogoff 1990). Modeling political decisions as temporally local is therefore sensible.

Second, Olson (1963) shows that institutions change slowly at most, except during unexpected crises or shocks when they can change abruptly. One such shock is an economic catastrophe, as when the Great Depression begat the New Deal in the United States. Another is war, as when rebellion severed the 13 American colonies from Britain and forced them to establish institutions of their own. Sudden technological change also can serve a shock, as when electrification changed corporate landscapes in the early 20th century. Although a few governments, such as Meiji Japan, undertake wholesale institutional reforms, they are notable by their rarity. We can consider periods in our model to be long enough to accommodate any reasonable government-planning horizon, and then view liberalization as a shock that necessitates a new optimal institutional development plan.

For clarity, we preclude the government catering to rent-seekers at this point, and assume politicians do not extract private benefits. This lets us illustrate the role of firm heterogeneity in institutional development even where the government is benevolent and rent-seeking is absent. Nevertheless, we recognize the importance of rent-seeking and therefore extend our analyses to include it in section 5.

The government’s cost of implementing institutional development level $\lambda$ is $g(\lambda)$, with $g'(\lambda) < 0$ and $g''(\lambda) > 0$. This cost includes the cost of basic public goods such as schools, courts, and police, plus the costs of more refined public goods such as accounting, banking, and the enforcement of securities regulations. While the cost of providing arbitrarily poor institutions is near zero, the government’s cost of supplying public goods rises prohibitively as institutional development approaches perfection. That is, $g(\lambda) \to +\infty$ as $\lambda \to 1$, and $g(\lambda) \to 0$ as $\lambda \to +\infty$. 

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The government determines the direction of institutional change by comparing the marginal benefits of stronger institutions, $-\partial Y / \partial \lambda$, with their marginal cost, $-g'(\lambda)$. Given this and equation (5), institutional improvement ($\lambda_1 < \lambda_0$) occurs if and only if

$$\frac{1 - z_0}{1 / bc + (\lambda - 1) / f(z_0)} \geq -g'(\lambda).$$  \hfill (6)

Inspection of equation (6) shows that the inequality is more apt to hold, and hence institutions more apt to improve, if $\lambda_0$ is lower, $z_0$ lower, and $f(z_0)$ larger. In particular,

1. The government sees a greater net benefit in improved institutions if incumbents have invested less in substitutes for weak institutions. This external reliance effect stems from a lower $z_0$, indicating lower past investments in such substitutes by existing firms, which raises the marginal benefit of institutional improvement, $\partial Y / \partial \lambda$.

2. The government sees a greater benefit in institutional improvement if the queue of potential entrants is longer. This entry push effect arises because a higher $f(z_0)$ implies that more potential entrants stand ready to go into business given marginally better institutions. Improved institutions therefore raise firm output more with a high $f(z_0)$.

The government’s decision about improving institutions depends crucially on the magnitudes of these two effects. For example, institutional improvement is slighter in an economy with more large business groups that rely little on domestic institutions. Such an economy has a high $\lambda_0$ and a high $z_0$, hence a small or even negative external reliance effect. If its queue of potential entrants, $f(z_0)$, is also short, the entry push effect is small too, and institutional improvement is even less apposite.

### 3.4 Discussion

This model, albeit simple, provides several key insights. First, it permits path dependence in institutional development, consistent with La Porta et al. (1997) and Acemoglu, Johnson, and Robinson (2005b), who argue that seemingly slight differences in countries’ levels of institutional development in the remote past magnified themselves over time into the gulf that currently separates developed from developing economies. The path dependence arises because past institutions affect the benefits and costs of institutional development.

Better, past institutions boost the current period’s entry push effect because they reduced entry barriers and thus encouraged investment in entrepreneurial capabilities.
(Murphy, Shleifer, and Vishny 1991). Better past institutions also let entrepreneurial firms grow (Beck, Demirgüç-Kunt, and Maksimovic 2006), and so increased the incidence and importance of “low $z$” firms in the economy. Meanwhile, better past institutions caused established firms to invest less in circumventing institutions (Ghemawat and Khanna 1998), rendering the current period’s external reliance effect larger by shifting $f(z)$ to the left. Ironically, firms’ rational investment in substitutes for weak external institutions has the externality of weakening even a benevolent government’s inclination to improve institutions further.

Path dependence arises also because the capabilities of institution building reduce the marginal cost of further institutional development from the government’s perspective. Although not explicitly in our model, the marginal cost $g'(\lambda)$ can readily be made dependent on institutional development, so that better past institutions shift the marginal cost curve of subsequent institutional improvements downward. Such dynamic economies of scale are intuitively plausible. For example, a better past provision of basic public goods (like schools, courts, and police) lowers the cost of implementing further institutional improvements (like transparent accounting or efficient bank loan allocation). The government’s monitoring and enforcement costs in implementing such reforms are reduced.

Our model departs from previous work in showing that institutional differences can arise, persist, and expand without political rent-seeking. This complements Almeida and Wolfenzon (2006), who propose that economies become mired in equilibriums with weak property rights and financial systems. Given this, a government may have difficulty committing to improving the financial system if the economy is populated mainly by business groups, which are relatively independent of ambient institutions.

Our model suggests that weak institutions become self-reinforcing to varying degrees, depending on what we term the economy’s external reliance and entry push effects. These, in turn, reflect characteristics of the corporate sector and the economy. Shocks that disrupt this balance might conceivably jolt an economy out of a weak institution equilibrium and onto a path of institutional improvement. An outward shift of demand or supply necessarily reduces the institution-circumventing capabilities required for survival—by raising the market price $p$ or reducing the supply cost $c$, which increases the external reliance effect, or by creating new opportunities for entrepreneurs (Gerschenkron 1962), which raises the entry push effect.

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4 Morck, Wolfenzon, and Yeung (2005) propose a weak institutions trap associated with political rent-seeking that induces similar path dependence.
The requisite shock might come from any source: technological change, changes in tastes, or falling trade barriers (Acemoglu, Johnson, and Robinson 2005b). A full analysis of the differences between shocks of different sorts is beyond the scope of this study. We therefore explicitly consider a shock due to collapsing trade barriers, but implicitly include shocks of more general provenance.

4. Openness

We begin by considering trade liberalization, and then show that the framework we develop for this extends readily to FDI liberalization.

4.1 Trade liberalization

Trade liberalization imposes world prices for traded goods on the domestic economy, rendering some industries more competitive and others less competitive. As indigenous firms face expanded profit opportunities as well as global competition, weak domestic institutions may constrain their ability to compete globally. This changes equilibrium output prices $p$, making the old level of institutional development, $\lambda_0$, suboptimal. Such arguments underlie the belief that openness promotes institutional improvement. However, this reasoning needs some unpacking, and its implications can be more complex.

Trade liberalization has many highly plausible positive economic effects, such as those derived from exercising comparative advantage. Abstracting from these, we focus on how liberalization affects a government’s choice of the level of institutional development.

We assume the economy has an export sector (X) and an import sector (M). For simplicity, we take the one-sector model from section 3 as our starting point, and assume that the output units of both the X and M sectors are normalized so that the equilibrium market price of both is $p_0$ and their total output is $Y_0$. Upon liberalization, both sectors confront world price: $p_x > p_0$ for the export sector and $p_m < p_0$ for the import sector.

To highlight the role of institutional development and keep the analysis tractable, we follow the small open economy assumption that neither domestic firms’ behavior nor the domestic economy’s institutions, $\lambda$, affect the global prices $p_x$ and $p_m$. Relaxing these assumptions allows a richer discussion, but does not qualitatively change the predictions of the model. This assumption is appropriate for most emerging economies, particularly at the early stage of their development. We continue to assume that the government maximizes welfare subject to the cost of insti-
tutions, and that the same institutional environment, $\lambda$, applies to both the $X$ and the $M$ sectors.

The key difference from the closed economy case is that, for firms in a small open economy, world supply and demand are perfectly elastic at world prices. In the $X$ sector, domestic supply increases and exceeds domestic consumption to permit exports. In the $M$ sector, domestic supply decreases and part of domestic demand is met by imports from foreign suppliers.

In the $M$ sector, where $p_m < p_0$, a group of domestic firms remains active in the economy after trade liberalization and produces $Y_{dm} < Y_0$, with the remaining demand met by imports, $Y_{fm}$. The profit of a domestic firm with institution dependence $z$ becomes

$$\pi(z, \lambda) = p_m - c \cdot [z + (1 - z)\lambda]$$

and the marginal domestic firm has $z = z_{dm}$ where

$$c \cdot [z_{dm} + (1 - z_{dm})\lambda] = p_m.$$

The new equilibrium becomes

$$\begin{align*}
\left\{ \begin{array}{l}
c \cdot [z_{dm} + (1 - z_{dm})\lambda] = p_m \\
Y_{dm} = \int_{z_{dm}}^{1} f(z)dz \\
Y_{dm} + Y_{fm} = D(p_m)
\end{array} \right.
\tag{8}
\end{align*}$$

From the first two lines in equation (8), we know that

$$(1 - z_{dm}) + (1 - \lambda)\partial z_{dm}/\partial \lambda = 0$$

and that

$$\partial Y_{dm}/\partial \lambda = -f(z_{dm})\partial z_{dm}/\partial \lambda$$

Therefore,

$$\frac{\partial Y_{dm}}{\partial \lambda} = -\frac{1 - z_{dm}}{(\lambda - 1) / f(z_{dm})}$$

\(59\) Asian Economic Papers
Comparing equation (9) with equation (5), where
\[
\frac{\partial Y}{\partial \lambda} = -\frac{1 - z_0}{1/bc + (\lambda - 1)/f(z_0)}
\]
we find some interesting departures from the results in the previous section.

First, the price adjustment factor, $1/bc$, is absent from the denominator here. Instead of the downward-sloping demand curve of a closed economy, domestic firms in an open economy face competition from goods perfectly elastically supplied by foreign firms. Consequently, a given institutional improvement induces a larger increase in the size of the domestic sector than in autarky. The contrast is greater if the density of marginal firms around the new equilibrium, $f(z_{dm})$, is greater.

Second, if a country with serious institutional deficiencies ($\lambda >> 1$) opens to the global economy, only its more institution-independent firms survive. The new marginal firm has $z = z_{dm} > z_0$. This economy’s “higher $z$” firms depend even less on sound institutions; so institutional improvement does little to strengthen their competitive positions.

This description of the $M$ sector suggests that trade liberalization need not have a uniform effect on a government’s incentive to improve institutions. In particular, a government has less incentive to implement high institutional standards if its surviving domestic firms are less reliant on its institutional environment and if imports are more desirable substitutes for local production.

In the $X$ sector, where $p_x > p_{0y}$, the domestic firms expand after liberalization until the marginal firm has a lower $z_{dx}$, where $c[z_{dx} + (1 - z_{dx})\lambda] = p_x$. Thus, $Y_{dx} > Y_0$. As in the $M$ sector, domestic firms now face perfectly elastic demand from overseas, implying a more critical role for institutional development in reducing their costs.

Because
\[
\frac{\partial Y_{dx}}{\partial \lambda} = -\frac{1 - z_{dx}}{(\lambda - 1)/f(z_{dx})}
\]
the marginal firm being located at $z = z_{dx} < z_0$ implies that the average active domestic firm, as well as the marginal one, now relies more on ambient institutions. Institutional improvement significantly strengthens the competitive positions of the marginal firm, and this effect is larger as $f(z_{dx})$ is larger. That is, the effect is larger as more potential entrants that were kept unviable previously by weak institutions and the limited domestic market enter the market.
The cumulative effect of all these factors determines the economy’s path of institutional change. As under autarky, this argument distills into the intuitive external reliance and entry push effects discussed in section 3.4.

Liberalization affects the external reliance effect in both sectors. In the $X$ sector, liberalization raises the profits of firms already operating and makes entry viable for lower $z$ firms. This strengthens the external reliance effect associated with further institutional improvement. In the $M$ sector, competition from imports reduces the profits of firms already operating and drives some fraction of them out of business. Because the surviving firms, on average, have a higher $z$, the external reliance effect associated with further institutional improvement weakens. The net impact of liberalization on the external reliance effect is thus indeterminate, and may well depend on the two sectors’ industry characteristics—capital intensity or regulatory constraints—and the country’s industry policies.

The entry push effect also changes in both sectors—by moving the equilibrium so the marginal firm in each sector has a different $z_0$ and thus a different $f(z_0)$. Because $p_x > p_0 > p_m$, it follows trivially that $z_{dx} < z_{dm}$. That is, the marginal firm in the exporting sector has less capability for dealing with institutional deficiency than its counterpart in the import substitution sector. This is potentially economically important. For example, many small-scale potential start-up businesses might be sensitive to institutional deficiency and would form a substantial mass in a range of $z$ lying far outside the closed economy viability threshold $z_0$. Under autarky, these virtual entrants might be so deeply infra-marginal as to have no effect on the government’s cost-benefit analysis regarding a marginal improvement to institutions. However, trade liberalization relocates the marginally viable export-sector firm to $z = z_{dx} < z_0$ and, if $z_{dx}$ becomes small enough that this mass of firms is rendered viable, the government sees a substantially enhanced value to marginally improved institutions.

Finally, in an open economy, the government’s preference for imports versus domestic production matters. In the $M$ sector, international trade lets imports meet domestic needs at a price independent of domestic institutions. This lowers the welfare loss to consumers caused by the institutional constraints on domestic firms. If the government’s social welfare calculus treats consumption of imports and domestically produced goods similarly, the entry push effect correspondingly weakens. However, if the government attaches more social value to domestically produced goods than to imports, this need not ensue. We return to this issue in the next section.
4.2 Foreign-direct-investment liberalization

The framework developed herein can be extended readily to encompass FDI liberalization in addition to trade liberalization. To do this, we merely permit the entry of multinational enterprises.

Multinational firms’ global organizations make them relatively independent of their host countries’ institutions. For example, multinationals facing dysfunctional local markets can turn abroad to place products, source inputs, hire skilled labor, or obtain financing. Desai, Foley, and Hines (2004) show that multinational affiliates operating in countries with weaker capital markets or creditor rights borrow more from their parent companies. In a study of U.S. corporations’ global research and development (R&D) activities, Zhao (2006) finds that subsidiaries in countries with weak intellectual property rights protection tend to undertake R&D whose value is highly dependent on the firms’ internal resources, so that leakage of these specific technologies to competitors would not greatly damage the firm. In short, compared with an average indigenous firm, multinationals have a greater resilience to local institutional deficiencies because their global resources can substitute for weak domestic institutions—at least to some extent.

In the M sector, competition from both imports and multinational subsidiaries reduces the profits of domestic firms already in operation, and drives some fraction of them out of business. If we take $Y_{fm}$ to be imports plus multinational firms’ local production, the algebra of the previous section is preserved with only one change: the government now draws social welfare from domestically owned domestic production, imports, and domestic production by multinationals. Plausibly, the social welfare contribution of multinational production might be intermediate between those of domestically owned production and imports.

A similar difference in social welfare would arise regarding foreign-owned production in the X sector. Due to their ability to overcome local institutional deficiencies, multinational firms might more readily expand production once trade liberalization creates an export market. Multinationals also would displace some indigenous firms, whose costs would be low enough to compete at the global price but higher than those of the multinationals. The remaining indigenous firms would be “high $z$” firms—perhaps those with substantial investment in political influence or capital access. Thus, the presence of multinationals in the export sector would reduce the governments’ incentives to bring about major reforms (Huang 2003).

Governments’ actual social welfare preferences regarding local production by multinationals probably vary across countries (Huang and Khanna 2003). At one extreme, a government might be indifferent between production by domestically owned
firms versus multinational subsidiaries, and thus perceive no welfare loss if poor institutions shift production from the former to the latter. This perhaps reflects the situation for countries with bilateral investment treaties described by Rose-Ackerman and Tobin (2005). These treaties provide foreign-owned firms with “national treatment,” letting them bypass local barriers. Rose-Ackerman and Tobin argue that such treaties often reduce the host-country government’s incentives to strengthen domestic property rights protection—consistent with multinationals being relatively independent of the quality of host country institutions, \( \lambda \).

5. Political rent-seeking

We now depart from a benevolent government, which chooses the level of institutional development by equating marginal social costs to marginal social benefits. The previous analysis shows that political rent-seeking is not necessary to explain path dependence in institutional development nor the mixed relationship between openness and institutional development. However, government officials are humans, and therefore have private interests that deviate from economic development and social welfare.

Political rent-seeking, lobbying, bribing, or bullying politicians can distort public policy to create economic rents for narrow special interests (Krueger 1974). This is a sufficiently prevalent phenomenon (Rajan and Zingales 2003; Acemoglu, Johnson, and Robinson 2005a) and our discussion is not complete without considering its implications.

To incorporate political rent-seeking, we extend the government’s objective function to include side-payments, or political rents, as follows:

\[
G = \eta \cdot Y + (1 - \eta) \cdot S - g(\lambda)
\]

where \( Y \) is the welfare function as defined in previous sections, and \( S \) is the side-payment the government officials receive from political rent-seekers. The parameter \( \eta \in [0, 1] \) reflects government officials’ preference for social welfare relative to side-payments.

Let each firm’s side-payment be \( s = s(z, \lambda) < \pi(z, \lambda) \), with \( \partial s / \partial z > 0 \) and \( \partial s / \partial \lambda > 0 \). A positive \( \partial s / \partial z \) means firms that are more institution independent make more side-

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5 We could make \( s(z, \lambda) \) a fraction of \( \pi(z, \lambda) \) where the fraction depends on the bargaining power between government officials and a rent-seeking firm. Although this might lead to interesting results, it is not necessary in delivering our main results. We therefore opt for simplicity and relegate this to future research.
payments, probably because they are more effective political rent-seekers. This is a plausible assumption for two reasons. First, high \( z \) firms may have invested in access to government officials and better means of influencing government decisions. Second, business group ties, even if constructed to bridge gaps in weak institutions (Khanna and Palepu 2000), also lower the government’s rent-seeking costs (Morck and Yeung 2004). Because high \( z \) firms gain more valuable political favors for a given investment in political influence, they invest more in side-payments to officials. As profit margins increase with \( z \), higher \( z \) firms also can afford larger side-payments. This cycle can become self-reinforcing: privileged firms remain privileged precisely because they make larger side-payments.

For a given institution-independence level \( z \), we also have \( s(z, \lambda) \) rising as the country’s institutional deficiency worsens; that is, \( \partial s / \partial \lambda > 0 \). Assuming \( \partial s / \partial \lambda > 0 \) is sensible because political corruption is linked empirically to weak institutions (Shleifer and Vishny 1993). This is also intuitively plausible, because the quality of institutions affects not only the level of economic activity, but also the distribution of profits across firms. A weaker institutional environment (a larger \( \lambda \)) shifts profits to firms that can better conduct business via alternative mechanisms (higher \( z \) firms). In other words, building government relationships or other alternative mechanisms is more valuable where institutions are worse.

The sum of the side-payment government officials anticipate is

\[
S(\lambda) = \int_{z_0}^{1} s(z, \lambda) f(z) dz
\]

(11)

Differentiating equation (11) with respect to \( \lambda \) yields

\[
\frac{\partial S}{\partial \lambda} = \int_{z_0}^{1} s_\lambda(z, \lambda) f(z) dz - s(z_0, \lambda) f(z_0) \frac{\partial z_0}{\partial \lambda}
\]

(12)

The two terms on the right-hand side reflect a trade-off between the size of each firm’s rent-seeking side-payment and the total number of firms making side-payments. Because \( \partial S / \partial \lambda > 0 \), weaker institutions induce each surviving firm to make a larger side-payment. However, weaker institutions also reduce the pool of surviving firms by raising the \( z_0 \) of the marginal firm, leaving fewer contributors to politicians’ Swiss retirement funds.

The net effect of institutional constraints on political rent-seeking, again, depends on the distribution of firm types. First, a weaker institutional environment keeps the output price higher and transfers a larger share of profits to more institution-independent firms, who can return the favor to government officials via higher side-
payments (see Fabella 2007 for a detailed description of how illegal gambling operators in the Philippines captured national and local government officials and law enforcement agencies with side payments.)

Hence, something akin to the external reliance effect arises: the government’s incentive to improve institutions is weaker as major rent-seekers are more independent of ambient institutions (i.e., a high $z_0$). As the first term on the right-hand side of equation (12) indicates, a high $z_0$ means any institutional improvement would erode a significant part of government officials’ side-payment receipts. Second, something similar to the entry push effect also arises. More limited latent entrepreneurial activity (that is, a low $f(z_0)$) causes government officials to expect fewer new side-payment contributors from a marginal increase in institutional quality. This is captured in the second term on the right-hand side of equation (12). Therefore, where a few privileged firms or business groups dominate the economy, as is common in developing countries, officials can extract higher rents if institutions are weaker and $\partial S/\partial \lambda > 0$.

The government, with equation (10) as its objective function, equates the marginal cost of institutional improvement, $-g'(\lambda)$, with its marginal gain:

$$-\frac{\partial G}{\partial \lambda} = -\eta \cdot \frac{\partial Y}{\partial \lambda} - (1 - \eta) \cdot \frac{\partial S}{\partial \lambda}$$

(13)

Because $\partial S/\partial \lambda > 0$, if government officials are interested in rent-seeking ($\eta < 1$), they prefer weaker institutions (a higher $\lambda$) than purely benevolent government officials do. Thus, rent-seeking aggravates the negative impact of low entry push and external reliance effects on the government’s incentive to implement institutional development. The more important rent-seeking is to officials (i.e., the smaller is $\eta$), the worse the rent-seeking equilibrium institutional quality is relative to that under a benevolent government.

Liberalization interacts with rent-seeking in interesting ways. Liberalization affects the first component in equation (13), $-\eta \cdot \partial Y/\partial \lambda$, as described in the previous section. Rent-seeking enters via the second component, reflecting the government’s marginal gain, $-(1 - \eta) \cdot \partial S/\partial \lambda$.

On the one hand, liberalization lowers $\partial S/\partial \lambda > 0$ and so discourages rent-seeking for two reasons. First, liberalization means prices are set abroad (at $p_m$ and $p_x$), and are unrelated to domestic institutions. Officials can no longer raise their rents by keeping prices high and thus pushing up the profits of “high $z$” firms. Second, facing perfectly elastic competition from abroad, rather than the downward sloping de-
mand curve of a closed economy, the domestic sector of an institutionally weak country is likely to shrink rapidly. This drains the pool of firms contributing side-payments to government officials. This accords with liberalization weakening established firms’ ability to maintain a beneficial (to them) status quo (Rajan and Zingales 2003). Thus, equation (12) shows liberalization decreasing $\partial s/\partial \lambda$, yet raising $\partial z_0/\partial \lambda$.\(^6\) Liberalization moderates the impact of rent-seeking on a government’s choice of a level of institution development. The degree of moderation varies with the pre-existing distribution of firm types.

On the other hand, an opposite movement of the equilibrium upon trade or FDI liberalization is not impossible. If weak local institutions hurt foreign competitors in the import sector by escalating the costs of importing or undertaking FDI, the local price could still deviate from the global price and be elevated by worse local institutions, $\partial p_m/\partial \lambda > 0$. Foreign competitors might be less sensitive to local institutions than domestic firms, or they may be no match in the local market for domestic firms with extensive investments in substitutes for weak institutions. Thus, if the local institutional environment is too weak—with red tape too binding, contract enforcement too capricious, or exchange rates too unpredictable—this might effectively repel multinationals and even foreign suppliers of imports. If so, “high $z$” domestic firms, with their extensive investments in substitutes for weak institutions, might actually lobby for exceptionally dreadful institutions to deter foreign competitors and safeguard their rents, which would not have happened in the closed economy.

Given this, the open and closed economy cases are similar, in that low external reliance and entry push effects reduce the government’s inclination to improve institutions. This happens first via the economic development term $-\eta \cdot \partial Y/\partial \lambda$ in equation (13) and second via its rent-seeking term $-(1 - \eta) \partial S/\partial \lambda$.

This consideration also explains why externally forced liberalization, without taking the composition of domestic players into consideration, can make things worse in certain circumstances. This is not merely an academic point. Governments have been observed enacting extreme anti-market domestic policies in conjunction with trade liberalization, including state interference in bank loan allocation, increased regulations in “sensitive” industries, and the like (Siegel 2007). Rodrik (2000) mentioned a number of “unorthodox policies” that East Asian countries rely on like export subsidies, domestic-content requirements, import-export linkages, patent and copyright infringements, restrictions on capital flows (including on FDI), and di-

\(^6\) This does not consider rent-seeking by foreign firms, which adds further layers of complication.
rected credit. Such policies might well strengthen the positions of “high z” firms by increasing the value of their capabilities for circumventing weak institutions. This is more likely to occur if the rent-seeking is more important.

In summary, rent-seeking reduces the government’s propensity to improve institutions because weak institutions channel profits to privileged firms who recycle them, at least partly, into side-payments to government officials. If surviving firms benefit little from strengthened institutions and the queue of potential entrants is limited, marginally weaker institutions do little to erode politicians’ rent income. Hence, rent-seeking aggravates the negative impacts of small external reliance and entry push effects on institutional development. Liberalization can mitigate this, as global competition limits the government’s ability to channel profits. Yet caution is warranted. In an economy whose existing firms are institution independent and invested in political rent-seeking, and whose weak institutions thus disproportionately hamper multinationals’ ability to compete in the domestic market, an externally imposed liberalization could even weaken institutions to benefit the privileged domestic firms and enhance political rents.

6. Conclusion

The large and insightful literature on globalization and institutional change usually contrasts indigenous firms with multinationals, taking institutions to mean legal, regulatory, and social constraints that lower transaction costs and therefore facilitate economic transactions, and thus economic development. Based on this recognition, we argue that heterogeneity across firms—and potential entrants—leads to varied economic benefits from institutional development, which influences the government’s efforts to implement institutional changes. Using this insight, we explain two well-documented phenomena in international economics: the path-dependent and divergent institutional development across countries, and the varied impacts of border liberalization on institutional development.

Specifically, we decompose the marginal benefit of institutional improvement into two components, an external reliance effect and an entry push effect. The external reliance effect captures the benefits firms glean from improved local institutions that lead to development of functional factor markets (e.g., banking, stock, and market for managerial talents). The entry push effect captures the benefits that potential entrants or firms with growth opportunities derive from improved institutions. A longer queue of potential entrants implies a larger expansion of output once the institutional constraints are removed.
Considering these two effects allows us to generate path dependence in institutional development without invoking political rent-seeking. We argue that a benevolent government compares the marginal benefit of institutional development against its marginal cost. Sounder basic institutions lead to larger external reliance and entry push effects, with more firms (and potential entrants) willing to invest in entrepreneurial skills and fewer inclined to invest in institution-circumventing substitutes. Thus, an initial gap in institutional development can lead to widely divergent institutional development paths, even if rent-seeking is absent. Adding rent-seeking further magnifies the negative impact of low external reliance and entry push effects on institutional development.

Opening up to the global economy alters the magnitudes of both the entry push and external reliance effects. Openness changes prices, inducing entry and exit in different industries. This alters the composition of firms in the economy and the queue of potential entrants, and so alters the value of further institutional improvement. If the balance shifts toward existing firms that would benefit from better institutions and if openness lengthens the queue of potential entrants, institutional improvement ensues. The opposite may happen if the balance shifts toward existing institutional-independent business groups and multinational corporations, who are able to leverage their internal organizations and global resources, respectively, to overcome local institutional deficiencies.

Therefore, globalization can release countries trapped in bad institutions, but need not always do so. Globalization disturbs the previous equilibrium, reshuffles the distribution of firms, and forces politicians to re-evaluate the net benefits of institutional development. Higher entry push and external reliance effects, deriving from better initial primary institutions, render openness more likely to induce further development of more advanced institutions, such as financial development. If political rent-seeking occurs, the different firms’ influence over political decisions also matters, but our conclusions do not depend on this.

References


