

Trade, inequality, and the political economy of institutions

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Abstract

This paper investigates the relationship between international trade and the quality of economic institutions. We model institutions as fixed costs of entry, in a framework that has two key features. First, preferences over entry costs differ across firms and depend on firm size. Larger firms prefer to set higher costs of entry, in order to reduce competition. Second, these costs are endogenously determined in a political economy equilibrium. Trade opening can lead to higher entry costs when it changes the political power in favor of a small elite of large exporters, who in turn prefer to install high entry barriers.

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1. Introduction

Economic institutions, such as quality of contract enforcement, property rights, rule of law, and the like, are increasingly viewed as key determinants of economic performance (Acemoglu, Johnson, and Robinson [1]). While it has been established that institutions are important in explaining income differences across countries, what in turn explains those institutional differences is still an open question, both theoretically and empirically.

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This paper investigates how exposure to international trade affects a country's institutions. This is an important question because it is widely hoped that greater openness could improve institutional quality through a variety of channels, including reducing rents, creating constituencies for reform, and inducing specialization in sectors that demand good institutions (IMF [21]; Johnson, Ostry, and Subramanian [23]). While trade openness does seem to be associated with better institutions in a cross-section of countries, in practice the relationship between institutions and trade is likely to be much more nuanced.¹ As documented by both historians and economists, in many instances international trade contributed to concentration of political power in the hands of groups that were interested in setting up, or perpetuating, bad institutions.² Thus, it is important to understand under what conditions greater trade openness results in a deterioration of institutions, rather than their improvement.

The goal of this paper is to provide a framework rich enough to incorporate both positive and negative effects of trade on institutions. We build a model in which institutional quality is determined in a political economy equilibrium, and then compare outcomes in autarky and trade. The production side of the economy is based on the Melitz [26] model of trade with heterogeneous firms and monopolistic competition. Firms differ in their productivity, face fixed costs to production and foreign trade, and have some market power. For a given fixed cost of entry, only sufficiently productive firms operate. Similarly, only the most productive firms export. Heterogeneous productivity implies that profits differ across firms, generating wealth inequality across agents.

In our model we interpret institutional quality as the fixed cost of production. When this cost is high, institutions are bad, and fewer firms can operate.³ The imperfectly competitive nature of the economy provides scope for rent seeking behavior. In the model, every producer has to pay the same fixed cost. We first illustrate how preferences over institutional quality depend on firm size. Each producer has a preferred level of the fixed cost, which increases with firm productivity: the larger the firm, the worse it wants institutions to be. Why would not everyone prefer the lowest possible fixed cost? On the one hand, a higher fixed cost decreases profits one for one, and same for everyone. On the other hand, setting a higher fixed cost prevents entry by the lowest-productivity firms, which reduces competition and increases profits. This second effect is more pronounced for firms with higher productivity. More productive firms would thus prefer higher entry barriers – worse institutions.⁴

¹ See, e.g., Rodrik, Subramanian and Trebbi [31], Rigobon and Rodrik [29], and Levchenko [25].

² In the 1700s, for example, the economies of the Caribbean were highly involved in international trade, but trade expansion in that period coincided with the emergence of slave societies and oligarchic regimes (Sokoloff and Engerman [34] Rogozinski [32]). During the period 1880–1930, Central American economies and politics were dominated by large fruit-exporting companies, which destabilized the political systems of the countries in the region as they were jockeying to install regimes most favorable to their business interests (Woodward [38]). In the context of oil exporting countries, Sala-i-Martin and Subramanian [20] argue that trade in natural resources has a negative impact on growth through worsening institutional quality rather than Dutch disease.

³ Narrowly, this fixed cost can be interpreted as a bureaucratic or corruption-related cost of starting and operating a business. For instance, Djankov et al. [15] document large differences in the amount of time and money it requires to start a business in a large sample of countries. More broadly, it can be a reduced-form way of modeling any impediment to doing business that would prevent some firms from entering or producing efficiently. For example, it could be a cost of establishing formal property rights over land or other assets. Or, in the Rajan and Zingales [27] view of the role of financial development, the institutional quality parameter can be thought of as a prohibitive cost of external finance.

⁴ This feature of the model corresponds to the increasingly common view that large firms are less affected by bad institutions than small and medium size firms. Beck, Demirgüç-Kunt and Maksimovic [8] find that bad institutions have a greater negative impact on growth of small firms than large firms. Furthermore, Rajan and Zingales [27,28] argue

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