Summary of the Dissertation of Kristine Farla
Empirical Studies on Institutions, Policies and Economic Development

The empirical analysis of institutions and policies as determinants of long-run economic growth is confronted with major methodological challenges in estimating the relative effect of various growth factors. The four cross-country studies collected in this thesis contribute to the literature in this direction. The scope of analysis is framed on the objective of establishing whether either the neoliberal approach or the structuralist approach is most fruitful in terms of stimulating economic development. The results suggest that countries have successfully combined both aspects of neoliberal and structuralist policy into their policy framework. Moreover, in agreement with the work of Justin Lin, what seems conclusive is that both certain neoliberal and certain structuralist policies should be recognized as important growth drivers.

The first study investigates the relation between institutions and financial development. Based on a literature survey on theories linking institutional foundations and financial development, three categories of institutions are outlined: property rights protection, security of contracts, and competition. Using data from the institutional profiles database 15 variables are identified that correspond to the above mentioned institutional characteristics. Next, principal component analysis (PCA) is used to construct three indicators corresponding to the different institutional characteristics. Hausman-Taylor estimations with Amemiya-MaCurdy specification reveal that the three institutional indicators are positively and significantly related to financial development. In this study financial development is measured using data on the credit to the private sector as a ratio of GDP. The result described above remains robust when controlling for the effect of financial policy.

The aim of the second study is to analyze the role of industrial policy in stimulating economic growth. Indicators for ‘pro-market’ and ‘pro-business’ type policies are constructed using the taxonomy of economic policy developed by Rodrik and Subramanian as a reference and using a set of policy variables from the IMD World Competitiveness yearbook. Pro-market policies are aimed at increasing competition and market access and pro-business policies support the development of the existing industry. The two indicators are positively correlated suggesting a positive relation between the levels of countries’ implementation of these policy types. On the one hand, fixed effect analysis suggests that pro-market policies have no clear effect on growth and income. On the other hand, the results indicate that pro-business policies are positively related to growth. Additionally, an indicator that measures innovation and technology is constructed using a sub-set of the pro-business policy variables. Additional estimations suggest that the positive effect of pro-business policy is to a large extent attributable to policy support for innovation and technological advancements.

The third empirical study investigates the effect of FDI on domestic investment, the effect of governance on domestic investment, and the mediating effect of institutions on the relation between FDI and domestic investment. This study is based on the work of Morrissey and Udomkerdmongkol (2012). These authors find a negative effect of foreign investment on domestic investment, a positive effect of institutions on domestic investment and a negative interaction effect of institutions on the relation between foreign and domestic investment. The authors interpret the negative interaction effect as evidence for their hypothesis that domestic investment is discouraged in countries with ‘unfriendly regimes’ unless investors have acquired a foreign partner. We view this hypothesis to be rather limited. Using theory on technology spillovers and political elite rent-seeking we propose that the sign of the interaction effect is dependent on whether the effect of foreign technology spillovers is more dominant than the effect or rent-seeking behaviour. We find that the results of Morrissey and Udomkerdmongkol (2012) are sensitive to the definition of the dependent variable. When, contrary to the method used by the authors, the level of foreign investment is not subtracted by the level of domestic investment the GMM results suggest that FDI crowds-in domestic investment. Moreover, the coefficients of the variables become less significant when using alternative GMM specifications. Following our preferred GMM specification we find *only* a weak relation between governance and institutions and we find some evidence of a negative mediating effect of governance and FDI on domestic investment. This negative mediating effect is interpreted as evidence that rent-seeking behaviour favours foreign investors at the expense of domestic investors. The study indicates that this effect dominates the effect of foreign technology spillovers on domestic investment.

The last study uses firm-level data on 101 developing and emerging economies to analyze both micro-level and macro-level determinants of investment. The study confirms that in developing and emerging economies firms frequently do not invest. In agreement with previous research we interpret this phenomenon to be a result of the high level of irreversibility of fixed capital. The determinants of both the propensity of investment as well as firms' investment to sales ratio (i.e. in the latter case provided a firm invests more than zero) are studied. The results of a multi-level Heckman selection model suggest that investment behaviour is heterogeneous in nature and that the macro-level impact on investment behaviour is relatively small. Moreover, following the results, firms that are completely foreign owned invest relatively less and less frequently than partially foreign-owned firms as well as domestically owned firms. One possible explanation is that foreign firms operate relatively more in extractive industries that require less long-term commitments. In addition, this study provides some evidence that in countries with better property rights protection and control of corruption firms invest relatively more frequently. Finally, the study suggests that there is a positive mediating effect of property rights protection and control of corruption on the relation between foreign ownership and firms’ investment to sales ratio.