Institutions as a Source of Comparative Advantage

Tomohiro Ara

University of New South Wales

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Abstract

It is empirically well-known that institutions — more specifically contract enforcement — are an important determinant of comparative advantage (Levchenko, 2007; Nunn, 2007). It is also widely known that only a small fraction of firms can export their product and the percentage of exporters varies drastically across sectors (Bernard and Jensen, 1999; Bernard, Eaton, Jensen, and Kortum, 2003). The existing theoretical literature has so far dealt with these two stylized facts separately, however, and the unified frameworks incorporating these two pieces of evidence have not been developed enough to address the following questions: (i) How is institutional quality related to comparative advantage and aggregate productivity? (ii) Does higher quality of institutions lead to a larger share/number of exporters?

To investigate these relationships, the current paper develops a general-equilibrium Ricardian model of North-South trade in which both institutional quality and firm heterogeneity play a prominent role in determination of comparative advantage. By adopting the concept of "partial contractibility" (Acemoglu, Antràs, and Helpman, 2007), the model assumes that each country is different in terms of contracting institutions (i.e., the degree of contractibility for relationship-specific investments by suppliers), and each sector is different in terms of contract intensity. Furthermore, each firm within each sector is different in terms of their productivity à la Melitz (2003). These three-demensional differences endogenously pin down the international pattern of specialization and trade in general equilibrium.

I show that a country with relatively better institutions (North) has comparative advantage in more contract-dependent products and is a net exporter of customized products, thereby leading on average to the higher aggregate productivity in North. The model also demonstrates that, relative to comparative-disadvantage sectors, the ratio of exporters to domestic firms is higher in more comparative-advantage sectors. Surprisingly, in some sectors, while the number of domestic producers is bigger in South, the number of exporters is larger in North. This implies that the so-called home-market effect (i.e., exports tend to reflect the characteristics of the home market) does not always work in the presence of imperfect institutions and heterogeneous firms.

Keywords: Contracting institutions, firm heterogeneity, comparative advantage
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