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Introduction: Openness, institutions, and long-run socio-economic development

Does opening up the economy favor growth? Do political and economic institutions affect the level and growth of economic activity? Do openness and institutions act simultaneously, and are there interactions between the two or are there effects of economic activity on openness or the quality of institutions? In this special issue ten contributions re-examine these long-standing questions.

Specifically, four papers deal with links between informal institutions and long-run socio-economic development. Scandinavian countries are well known for a unique combination of a generous welfare state with high average levels of income and also for the highest levels of social trust in the world. From a purely economic perspective, the Scandinavian model appears to be a puzzle because of the incentives for free riding (and cheating) that come with the implicit high levels of taxation. So it looks as if the Scandinavian model works because of the prevailing level of social trust. However, this only invites the next question: where does Scandinavia's high level of social trust come from? Gert Tinggaard Svendsen and Gunnar Lind Haase Svendsen argue that one possible historical root of social trust could be the trade practices of the Viking age. While the Vikings have often been portrayed as warriors and raiders, their role as traders – down the Atlantic coast into the Mediterranean Sea and across the Baltic Sea into the Black Sea via the rivers of Russia – has received much less attention. In the non-literate Viking society, long-distance trade between strangers required a strong informal institution of trust-based norms to deal with the risk of being cheated and the risk of being treated as a cheater. The rise of trust-based trade norms in the age of the Vikings is thus held to be one of the factors in understanding Scandinavia's outstanding level of social trust.

The potential relevance of social capital accumulated in the 18th and early 20th century is studied in a paper that looks at the variation in economic performance across Chinese provinces. The main problem with empirical studies of social trust have been its measurement and its potential endogeneity, i.e., the possibility that social trust may be an outcome variable rather than a determinant of long-run economic success. Zhiqiang Dong and Yongjing Zhang use the fraction of Chinese students studying in foreign countries in the years 1847–1949 as a proxy for historically accumulated social capital, which is believed to be exogenously determined by the distance from each provincial capital to the nearest seaport. While it is obvious that present performance cannot affect the past share of students abroad, the latter can be plausibly related to the level of open-mindedness and social trust that prevailed in the historical period. The empirical results of the paper indeed suggest that accumulated social capital affects contemporary economic performance through its effects on present levels of social capital and on improved institutions.

Informal institutions also play a role in a paper that asks how a government will behave when it faces a general election and, therefore, wants to please voters with higher public expenditures but cannot do so because of an already high level of public debt. Privatization of public assets is an obvious solution. Massive privatizations were implemented in the former socialist countries, especially in the first decade of the transition when privatizations were an important part of a country's structural reforms on the way to becoming a market economy. For the case of Albania, Endrit Lami, Drini Imami, and Holger Kächelein show that the timing of privatizations demonstrates a clear pattern: privatization occurred mainly at the end of the political cycle, not at the beginning. This confirms a pattern predicted by political business cycle theory, where incumbents engage in fiscal expansion in order to increase their chances of re-election. For the country as a whole, this pattern of behavior will most likely generate a bad outcome because the aim is not to maximize public revenues but to keep the incumbent government in power. Observed waves of privatizations in Albania cases in point.

Government ideology as determined by political party ideology may be considered another informal institution that shapes human behavior and socioeconomic outcomes. Chun-Ping Chang, Yu Hao, and Jun Wen assess how governments with

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different ideologies react to a perceived conflict between economic performance and environmental quality. Conventional wisdom has it that left-wing governments prefer environmental quality over economic performance whereas right-wing governments prefer the opposite ordering. This outcome is generally supported in the sense that left-wing parties are more willing to formulate radical environmental regulations and pollution is expected to decrease after left-wing parties gain power. However, the preference of left-wing parties for environmental quality is apparently conditional on the business cycle. When under pressure from voters for improved economic performance, it appears that left-wing parties change course, which is a result at variance with conventional wisdom but in line with political business cycle theory. Less surprisingly, it also turns out that "anti-growth economy" parties persistently prefer environmental quality. But it seems that Christian democratic parties, which tend to be right-wing in the terminology of the paper, exhibit an attitude of being environmentally friendly in OECD economies.

Although centrally planned economies also featured growth cycles that were largely due to the nature of the planning process, output became increasingly volatile after transition. Merima Balavac and Geoff Pugh investigate the role of trade openness, export diversification and institutions as potential predictors of the volatility of GDP per capita in 25 transition economies between 1996 and 2010. Using non-overlapping averages of the annual data, GDP per capita volatility measures are calculated using the standard deviations of successive 3-year periods. The authors use both fixed effects and GMM-systems estimation with internal instruments to take account of the potential endogeneity of openness and institutional quality although the main findings of the two estimation methods are similar with respect to sign, significance and order of magnitude of effects. Specifically, more diversification attenuates the positive effect of openness on output volatility only at lower levels of diversification. Importantly, the type of diversification matters: the volatility effect of openness is dampened by diversification along the intensive margin (i.e., as the country moves towards a more equal distribution of export shares across existing export products), but not by diversification along the extensive margin (i.e., as a country increases its range of exports). Improvements in the quality of – especially political – institutions also attenuate output volatility. Lack of political rights and problems with polity in the broader sense emerge as the most important institutional characteristics affecting output volatility in transition countries.

Opening up an economy through trade and investment liberalization promotes – through stronger competition – an efficiency enhancing reallocation through crowding-out and selection effects. Surprisingly, the response of local firms to foreign firm entry by merger has so far received little attention in the empirical literature. Katja Zajc Kejžar's contribution aims to fill this gap by simultaneously examining both the crowding-out and merger-encouraging effects of inward FDI and imports, based on panel data on more than 7500 firms operating in the Slovenian manufacturing sector between 1994 and 2003. Multinomial probit results confirm that increased import competition raises the probability of incumbent firms exiting the market. In contrast, the competition effect of foreign firm entry via FDI is of a static nature: competitive pressure increases upon entry, but there is no evidence of a continuous competition effect on crowding-out or mergers as a result of foreign firms' local sales growth.

For many of the poorest countries, especially those without exploitable natural resources, the main source of inflows of funds from abroad is not FDI but rather development assistance funding from international agencies, individual donor countries and NGOs. While such inflows of money have the potential to stimulate development and alleviate poverty, development assistance funds are often "captured" by local elites, thus furthering domestic rent seeking, forestalling the development of stronger institutions, and financing the recycling of development funds out of the country through capital flight. At the same time, poor countries that lack good institutions will have badly performing economies and are thus more likely to be the recipients of foreign assistance. While there are numerous studies that examine the relationship between corruption and aid from one side or the other, the bi-causal relationship between development assistance and the level of corruption in the recipient countries is investigated by Audrey-Rose Menard and Laurent Weill in a way that deals with the bi-directional causality in this relationship in an explicit way. The authors employ a panel that includes 71 countries for the period 1996–2009. They test for Granger causality within the panel framework using system GMM dynamic panel estimation. They find that, based on their estimates, there is no Granger causality between developmental aid and corruption in the recipient countries. The results, while surprising, are confirmed by a battery of robustness tests. The findings are rather positive for donor countries and organizations insofar that there are no negative externalities to offering aid to poor countries.

Dominik Völlmecke, Björn Jindra, and Philipp Marek examine the convergence of income across 269 European (NUTS2) regions over the years 2003–2010 and also in a subsample of regions in the Central and East European countries (CEECs). The authors identify two drivers of potential regional income convergence. The first is the amount of FDI entering a region, which influences regional income through several channels including FDI spillover effects on technological progress. The second is the accumulation of human capital in a given region, as such capital is critical for the incorporation of new technologies, many of which are implanted in the region through FDI. The literature is quite clear that both the ability to attract FDI to a region and the willingness and ability of individuals to accumulate human capital depend in large part on the quality of the institutions that characterize a country or region. The authors construct a time-invariant transition matrix that shows the probability of a region moving from one income group to other income groups or levels. They find overall mild convergence of regional per capita incomes, but also that there is a within-country lack of convergence for the CEECs, with regions such a capital cities and border areas improving while other regions do not, so that divergence seems to be increasing. They also find that EU regions with larger per capita stocks of FDI do not enjoy higher growth rates, even if they may have higher per capita incomes. On the other hand, human capital accumulation appears to have a clear effect on a region's ability to increase its per

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capita income. These findings suggest that greater expenditures on education as well as the development of institutions that support individuals' willingness to invest in human capital accumulation can play an important role in reducing regional disparities.

The expansion of the EU and the trend toward broader multinational agreements to liberalize trade and investment makes a country's regulatory regime ever more important since burdensome regulations can more easily be avoided by shifting consumption toward imports or to offshore sourcing of products by domestic firms. Thus the effects of trade liberalization and regulation on economic growth are intertwined. In their contribution to this special issue, Magdalene Silberberger and Jens Königer examine this relationship and find that both the quality of regulation and openness to trade have a positive effect on economic growth. Of course, the notion of regulatory quality is an ideologically charged one, and the authors make an effort to deal with this problem. They also have to deal with the usual endogeneity issues that confront every study of the causes of growth. The authors find a strong but non-linear relationship between growth and regulatory quality. Thus whether or not to devote resources to improving regulation depends on a country's level of development.

Trade and investment liberalization in Europe in its ultimate form, i.e., by expanding the European Union, is expected to result in real as well as financial convergence. Mihai Niţoi and Miruna Pochea investigated the financial convergence among Central and Eastern European (CEE) countries that are members of the European Union (EU) for the period 2007–14, which covers both the global financial crisis and the sovereign debt crisis. To examine the convergence dynamics of these financial markets, the authors employ a club clustering algorithm that uses a non-linear single factor model, investigating capital markets, sovereign risks, and the banking sectors. Although the findings reveal clear regional linkages, the authors reject the convergence hypothesis for financial markets in CEE for all countries in the panel. Rather, the findings show an obvious segmentation of CEE stock markets and banking systems and reveal heterogeneity of sovereign risks across the region, i.e., point to the existence of a highly fragmented financial market in which structural and institutional differences remain high.

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