ARTICLE IN PRESS
REVECO-01155; No of Pages 3
International Review of Economics and Finance xxx (2016) xxx–xxx

Contents lists available at ScienceDirect

International Review of Economics and Finance

journal homepage: www.elsevier.com/locate/iref

The political economy of development in a globalizing world

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ARTICLE INFO

Available online xxxx

Keywords:
Globalization
Political economy
Growth
Inequality
Economic reforms
Trade taxes
Modernization
Privatization

ABSTRACT

The topics in this issue include the political economy of economic reforms, privatization and labor, structural change and growth, democracy and policy volatility, the role of trade intermediaries in the avoidance of export taxes, and the impact of the middle class on democratization and the international propagation of democratic values.

1. Introduction

While world income has increased several folds over the last century, there is still very high incidence of extreme poverty in many parts of the world and inequalities of various types are widespread all across the globe. Yet economic policy formulation still remains governed by political factors. The enlargement of national and global pies, arising mainly from the integration of economies and the removal of barriers to the movement of goods, services, capital, and people, has affected the scope of the influence of special-interest (or pressure) groups, bureaucrats, and other political actors. It has also had an impact on political, economic, and legal institutions in economic decision making as these institutions define constraints and incentives that shape human behavior. This special issue invited articles exploring the role of the above influences in major development issues including, but not limited to, poverty, inequality, trade, human development, and health.

We were open to the submission of both theoretical and empirical articles. As readers will see, we ended up with exactly equal number of each type published in this special issue (six published articles, three of which are theoretical and the remaining three empirical). In addition, the articles vary also in terms of the questions or issues they deal with and the methodologies they use. Questions tackled in this special issue include the role of state capacity in reform implementation when political economy forces are taken into account, complementary policy reforms along with privatization to make the latter inequality reducing (and therefore politically more palatable), reasons why certain types of property rights had promoted desirable structural change and economic growth in parts of Europe prior to the Industrial Revolution while others did not, the role of democracy in the stability of trade and fiscal policy stability, the role played by export intermediaries in helping producers minimize the payment of export taxes, and finally, the contribution of middle classes around the world in improving democratic conditions (by fostering democracy both within their own countries as well as in their neighboring countries).

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http://dx.doi.org/10.1016/j.iref.2015.10.020
1059-0560/

Please cite this article as: Mitra, D., & Ulubasoglu, M.A., The political economy of development in a globalizing world, *International Review of Economics and Finance* (2015), http://dx.doi.org/10.1016/j.iref.2015.10.020

2. Theoretical contributions

The paper by Jain and Majumdar examines the role state capacity plays in the adoption of reforms. Any kind of reforms, such as trade reforms, creates winners and losers. Even if the gains from these reforms to winners exceed the losses to losers, it is quite possible that losers outnumber winners. In such situations, reforms can get the necessary popular support if the government can commit in advance to compensating the losers. However, the identification of winners will require administrative or state capacity. If the payoffs to individuals from the reforms are exogenous, it is fairly straightforward to see that higher state capacity helps with the adoption of reforms.

As argued by Jain and Majumdar, these payoffs might not be exogenously given. In response to reforms being adopted, individuals make investments that, in turn, affect their payoffs. Greater state capacity helps identify winners. This greater ability of the state to identify winners has two effects. First, it expands compensation possibilities for given pre-tax payoffs. The second effect is that it discourages investment by lowering post-tax payoffs or reward to investments. This lowers the size of the overall pie and, in turn, shrinks compensation possibilities. The combined result of the two effects is that at both very low levels and very high levels of state capacity reforms will not be adopted. Adoption of reforms will take place only at intermediate state capacity. As pointed out by the authors of the paper, the findings of the European Bank for Reconstruction and Development for the twenty transition economies during 1989–99 show that the maximum progress was made by those in the middle in terms of governance levels.

Based on the results, we believe that one of the important policy implications is that at times it might be welfare enhancing in the aggregate for the state to operate at less than full capacity. While the state might have already invested in building a large capacity its capacity utilization in any particular area will depend on its administrative employment and the other variable expenses it incurs. This is an important corollary that comes out of this work.

The next paper is by Chao, Nabin, Nguyen, and Sgro, who study the role of privatization in wage inequality in a theoretical model of dual economy with skilled and unskilled labor. We believe this is an important contribution because globalization is often blamed for higher wage inequality, with reforms such as trade liberalization and privatization often taking place simultaneously. Increased disparities between skilled and unskilled wages around the world can have several reasons: globalization, skilled-biased technologies, unemployment, immigration, foreign investment, and other political and institutional factors. The authors argue that privatization of state-owned enterprises can result in changes in the rewards to skilled and unskilled labor and, hence, may constitute another determinant of disparity. The authors consider an oligopolistic framework for an open, dual developing economy with urban unemployment, where skilled workers provide managerial services and unskilled workers produce goods. Their results indicate that in the short run, increased privatization can narrow the wage gap between skilled and unskilled labor. However, the narrowing wage inequality following privatization vanishes or is even reversed in the long run with free entry and exit of public firms. The implication of this result is that in developing countries, the excessive number of public firms can act as a source of rising wage inequality following the privatization drive.

The authors provide the examples of China and Vietnam to aid the interpretation of their results. In these countries, during the privatization drive of state-owned enterprises (SOEs) in the 1990s and the 2000s, a skilled labor shortage arose for managerial and technical services. The wages of skilled labor thus increased, leading to higher wage inequality between the skilled and unskilled labor. In the light of these results, the authors recommend, for a more sustainable long-run development, a policy of regulating the firm entries in the short run. This will work to avoid rising wage inequality. This policy should then be accompanied by complementary reforms that are aimed at mitigating the loss from output contraction during privatization, such as freer inflows of foreign capital or skilled labor. We believe this will also make such reforms politically more palatable.

The third paper in this issue is by Karayalcin, where he provides a theory for why, even prior to the Industrial Revolution, certain parts of Europe, such as England and the Lowlands (the current Netherlands), experienced structural change from agriculture to industry and why they experienced overall and manufacturing growth long before other parts of Europe did (as recently found by many prominent economic historians). The author's argument is based on differences in property rights. In Western Europe, there were a large number of peasant proprietors or landholders, each owning a small plot of land. At the other extreme was Eastern Europe, where arose what is called the “second serfdom” due to the domination of the feudal lords. Thus, there were landless peasants working on large plots of land owned by a few landlords. In both cases, it is easy to see that the demand for manufactures is relatively small.

As the introduction of relatively advanced manufacturing industries requires large fixed costs to be incurred, their viability needs a large market size. In the Northwestern part of Europe, namely England and Netherlands, there was an intermediate number of landowners, each with a moderately sized piece of land. This led to the creation of adequate demand (and, therefore, a large market size) for the feasibility of a large variety of manufactures. As a result, there was growth and structural change taking place in these countries well before the Industrial Revolution.

This paper shows that institutions matter for structural change and in creating growth. One can argue that these institutions often reflect the polity of the country and have economic implications. Recently, in the context of development, especially in the presence of globalization, the issue of structural change has started receiving considerable attention. Thus, this paper, while focusing on economic history, has important policy implications for the present developing countries.

3. Empirical contributions

The fourth paper of this special issue is by Dutt and Mobarak, who analyze the role of democracy in the stability of policy choices. The authors' starting point is the long-standing, and what they argue to be inconclusive, debate on the democracy–

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economic growth relationship. They posit that, instead of focusing on the role of democracy in average growth performance, exploring its effect on the second moment of economic performance (i.e., volatility) can be more promising. In this respect, they propose a theoretical link between democracy and policy stability, whereby democracy is equated with decentralized decision making in which several agents take part in assessing the signals sent by each policy option. The authors argue that the greater number of the agents that participate in the decision-making process, the more likely it is that “correct” policies are chosen, such that they would endure in the time period that follows.

Next the authors proceed with their empirical analysis. They focus on stability in fiscal policy and trade policy as outcome variables to be explained. To address the challenge of causality from democracy to policy stability, they employ multiple identification approaches, including propensity-score and nearest neighbor matching, instrumental variables, difference-in-differences, and panel with fixed effects methods. Across a range of specifications, they find that a one-unit increase in the polity score of democracy is associated with about a 3–5% decrease in the volatility of fiscal and trade policies in a country. Further, their mechanism explains up to two-thirds of the negative correlation between democracy and output volatility.

In the next paper, Liu, Shi, and Ferrantino examine how trade intermediation in China facilitates tax savings and/or evasion by exporters. In other words, it uncovers another role that trade intermediaries may play above and beyond the standard ones in the literature.

In China, exporters are provided partial VAT rebates, as opposed to full rebates in many other countries. The formulas used for these rebates differ between direct and indirect exporters (the ones that use trade intermediaries). The difference between the two formulas leads to substantial tax savings through the use of export intermediaries. In addition, intermediaries facilitate export price underreporting, which leads to significant tax evasion. Thus, the use of trade intermediaries is quite attractive to exporters. Liu, Shi, and Ferrantino investigate these tax savings and evasion using data from China. They also discuss the possible political economy reasons for the existence of the these rules governing the formulas for VAT rebate rules for exporters, for which they have to identify both the winners and losers from such a system of taxes.

In the final paper of this special issue, Chun, Hasan, Rahman, and Ulubasoglu investigate the role of the middle class in democratic diffusion around the world. The authors' starting point is the democratization waves that occurred in several parts of the globe in the past three decades. The recent Arab Spring and the preceding democratization of Eastern Europe epitomize vivid cases whereby increased democratic demands challenged the incumbent regimes in an attempt to improve democratic conditions. An important question here is why do certain countries join these attempts and others do not? The authors argue that countries with larger middle class sizes are more likely to join these attempts. The authors link this argument with two explanations of democratization: democratic domino theory and the modernization hypothesis. The democratic domino theory posits that increased democratic demands spill over neighboring countries through a “demonstration” effect, and middle classes are more likely to be engaged in demonstrations that trigger similar movements in the neighboring countries. The authors label this effect “the middle class-driven democratic domino theory.” The modernization hypothesis, on the other hand, postulates that increased living standards drive a demand for better democratic conditions. The authors, in this context, echo the long-standing but empirically untested view that middle classes are more likely to be the drivers of higher living standards, and hence, increased demands for democracy. They label this effect “middle class-driven modernization hypothesis.”

Using a panel data set of 145 countries over 1985 to 2013, the authors empirically test the “middle class-driven modernization” hypothesis and “middle class-driven democratic domino” effect. In their setting, an increase in the size of middle class within a country captures the “middle class-driven modernization,” while an increase in the size of a country's neighbors' middle class captures the “middle class-driven democratic domino” effect. The authors use three measures of middle class: an absolute measure of middle class (i.e., the proportion of population living on PPP\$2–\$10 per day) and two relative measures (i.e., the proportion of population falling between 75% and 125% of the median expenditure, and the share in the total expenditure of the middle 60% of the consumption distribution). Their empirical results indicate that the “middle class-driven modernization” hypothesis is supported in the sample of developing countries that excludes Eastern Europe and Central Asia. Thus, former socialist countries of Eastern Europe and Central Asia do not seem to host middle classes that demand increased democratic standards. The authors also find that the “middle class-driven democratic domino” effect is empirically supported in the sample of developing countries that excludes East Asia and the Pacific. This finding could be driven by China and other undemocratic countries in the region in that the neighbors of these countries do not enjoy higher levels of democratic standards. Overall, the authors' results suggest that middle classes in a reasonably large number of countries have contributed to improved democratic conditions by fostering democracy both within their own countries as well as in their neighbors.

4. Conclusions

This special issue offers a wide variety of contributions on issues related to political economy, development and globalization. More specifically, the topics include the political economy of economic reforms, privatization and labor, structural change and growth, democracy and policy volatility, the role of trade intermediaries in the avoidance of export taxes, and the impact of the middle class on democratization and the international propagation of democratic values. This special issue is well balanced with three theoretical and three empirical contributions.

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