Contracting Institutions and Economic Development

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Abstract

This paper studies the effects of contracting institutions on economic development. A model is presented with endogenous incomplete markets, where financial frictions generated by the imperfect enforcement of contracts depend on the future growth of the economy, which determines the costs of being excluded from financial markets after defaulting. As the economy approaches its steady state, frictions and their effect on income become more important because the net benefits of honoring contracts fall. Therefore the model predicts that contracting institutions affect GDP per capita in the last stages of development. This effect is not only due to a slower accumulation of capital, but it is also caused by a misallocation of resources toward labor intensive sectors of production, where self enforcing incentives are stronger. To validate this hypothesis I use cross-country regressions to estimate the effect of contracting institutions on per capita GDP. In line with the main predictions of the model, the econometric evidence shows that this effect is larger in richer economies, and it has taken place mainly over the last 60 years.

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