IGC International Growth Centre

Multinationals and Growth in Developing Countries

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Summary:

Results: Recent work has highlighted how the lack of reallocation in developing countries hampers their growth. In the US productive firms grow rapidly, creating jobs, while unproductive firms tend to shrink and exit. In developing nations we see far less of this reallocation occurring – productive firms do not grow rapidly and unproductive firms survive for many years. This reduces aggregate growth. Our paper investigates the reasons for this and finds that a major factor appears to be low levels of trust, often called "social capital", in developing countries. One mechanism for this is that in developing countries entrepreneurs are afraid of employing non-family members in their business as they are concerned that they may not act in the interests of the firm. As a result they struggle to expand as they run out of managerial capital if they grow too large (the size of the firm is determined by the size of the family). We investigate this using a large international dataset on firms, finding strong evidence for a causal impact of trust on firm size and growth.

Policy Implications: The key policy implications are that policies to improve trust are essential for building trust and helping firms expand. Political stability and stable communities are valuable not only in their own right but also have positive effects on the economy as mechanisms for building trust. Another policy is to improve civil courts and contract enforcement: even if trust is low effective rule of law might act as a substitute for trust. This process occurred in the US in the late 1800s and is necessary now in many developing countries. The importance of trust is a policy challenge though, as these cultural factors take a long time to change. It is a warning to policy makers to be careful in embarking on policies that could erode trust.

Audience: Policy makers in finance, industry and commerce Ministries in developing countries, plus policy advisers in international organizations like the World Bank working on industrial growth.

Research details:

Our research team collected management, organizational and performance data on around 10,000 firms across 20 countries, including several developing countries. In the paper we matched data for 12 countries to information on economic development, ownership, legal environment and trust. We find strong evidence that, first, firms operating in high-trust areas tend to be much more decentralized. The top management is more willing to entrust decisions on hiring, investment and product choice to middle and lower management. This is true both for domestic firms and also multinationals – for example, a US multinational operating in Assam (a low trust region in India) is less likely to be given managerial autonomy than a US multinational operating in Maharasthra or Karnakata (relatively high trust regions in India). We also find that this decentralization is strongly linked to firm size – firms in high trust regions are larger. The mechanism seems to be that by decentralizing control firms can grow their business more easily by using more mid-level managers.

The policy implications are that building trust in a country can help firms to decentralize management power, enabling them to grow. For example, in other IGC sponsored field work we have been doing in India we repeatedly came across firms that could not expand because they have exhausted the supply of family members willing to take management roles in the business. Since the family members did not trust outsiders because they worried they would steal from the firm, these firms stopped growing. To build trust it appears the building an effective legal system is essential. In the US or Northern Europe outside managers are allowed to run businesses because owners of firms are more confident that any theft can be punished through the courts. For example, a manager found stealing millions of dollars from a US firm would almost certainly be prosecuted, sent to prison with the money recovered. As a result they would be less likely to commit the fraud, and so would be more likely to be allowed to run the company. In contrast in countries like India legal systems are weak so that firm owners know there are very weak sanctions on managers caught stealing, so do not want to give them with decision making power.

Thus we argue that effective courts and systems for enforcing contracts and punishing theft are essential for the growth of large efficient firms. Without these firms are constrained by the size of family networks and the number of long-serving (trusted) managers.

A further way in which trust can be built is through political institutions to promote democracy and the protection of minorities. We find that trust is often lower between people of different religions – indeed we find that trade and investment between countries is higher when religions are more similar. So protection of religious minorities is a way of building trust between communities which will benefit growth. Put another way, policies that may undermine trust can have first order negative economic consequences.

***Further Readings**:*

"Regulation and distrust", by Philippe Aghion, Yann Algan, Pierre Cahuc and Andrei Shleifer, NBER Working paper 14648 http://www.nber.org/papers/w14648.pdf

"The organization of firms across countries", by Nick Bloom, Raffaella Sadun and John Van Reenen, Stanford mimeo.
http://www.stanford.edu/~nbloom/Org_2011.pdf

"Does management matter: evidence from India", by Nick Bloom, Benn Eifert, Aprajit Mahajan, David McKenzie and John Roberts, Stanford mimeo.
http://www.stanford.edu/~nbloom/DMM.pdf

"Management practices across firms and countries", by Nick Bloom, Christos Genakos, Raffaella Sadun and John Van Reenen, Stanford mimeo
http://www.stanford.edu/~nbloom/AMP.pdf