LACK OF “SOFT INFRASTRUCTURE” KILLS DEVELOPING ECONOMIES

FAYETTEVILLE, Ark. – Ten years ago Russia chose its first elected leader in more than 1000 years and had high hopes for a prosperous future. Today the economy is in shambles and everyone wants to know why. University of Arkansas economist Raja Kali has the answer – Russia lacks “soft infrastructure.”

“Some of the most significant economics lessons of the past decade have been learned from the grand experiment of entire economies trying to move from a system with more government intervention to a more market-driven system,” Kali said. “Economies don’t function in a vacuum. An important part of the problem is that the Russian economic system, like many emerging countries, lacks ‘soft infrastructure’ – the basic legal and financial institutions that we take for granted.”

Kali and Maitreesh Ghatak of the University of Chicago have studied the economies of developing countries from giants such India and Mexico to smaller countries in southeast Asia, Latin America and the countries of the former Soviet Union and found striking similarities. Their findings will appear in an upcoming issue of the journal Money and Finance.

“While Russia and Mexico seem very different, they have some of the same problems, including an inadequacy of soft infrastructure and a preponderance of diversified business groups,” explained Kali. “These diversified business groups may both facilitate and
hinder the development of market economies in many countries, depending on their position in
the transition process.”

Diversified groups are remarkably similar in different countries. They often emerge from a
family business and have financial interlinkages, trade ties and personnel exchanges. Although
they cover diverse industries, they usually are not integrated like a conglomerate, but they are
not independent subsidiaries, either. For example, India’s House of Tata includes firms in
industries such as steel, watches, trucks, tea and computer software and Chile’s Grupo Luksic
has interests in banks, hotels, mining, beer and pasta.

“These groups seem to defy the modern management mantras about core competence and
focus,” said Kali. “This may be why little research has been done into their function in the
economies of developing countries.”

Early studies focused on the sociological aspects of group interdependence. However, Kali
found that these groups arise when the legal, financial and educational infrastructure of a country
does not support the efficient function of a market economy. For example, if a country has a
corrupt, slow or unreliable legal system that does not support or enforce contracts, diversified
business groups make doing business safer.

Diversified business groups are also a response to labor market problems. In India and
Argentina, where laws make it difficult to fire people, workers can be moved around between
group members as company needs dictate. Through management training programs, these groups
can overcome shortfalls in the educational system and provide their own supply of skilled
managers, which are often in critically short supply in developing countries.

These groups can also develop their own distribution channels, thus overcoming the
inadequate communications infrastructure often found in developing countries. And they may
compensate for weaknesses in financial institutions, serving as venture capitalists to fund
potentially risky projects that banks and other financial institutions cannot support.

However, diversified business groups also present problems as a developing country moves
from the third world to a market economy. They are inherently rigid and do not adjust easily to
changes in the economic environment. And because the can operate as monopolies, they can
have a negative effect on other companies seeking to enter a market.

“Firms are often hesitant to experiment with firms outside the network even when outside
firms have more favorable offers,” Kali explained. “Persisting with a high-priced supplier
because of the trust that was developed can generate inefficiencies as new entrants have difficulty in competing. These rigidities may have serious macroeconomic implications and may explain some of the problems of recovery from recent crises in several emerging economies.”

While diversified business groups may impede the development of a market economy, Kali is quick to point out that the soft infrastructure of legal, financial and education institutions that developed countries take for granted are an important prerequisite to establishing a market economy. Until this soft infrastructure develops, Kali believes that “there may be sound economic reasons to allow diversified business groups to flourish.”

“We saw these types of groups in the United States in the past, but there is no longer a need for them. They serve a useful role at a particular stage of economic development,” said Kali. “As changes in the economy lead to modernization, they begin to unravel. But it is a painful transitional process, particularly for the older generation.”