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Institutional reforms, productivity and profitability: From rents to competition?

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ABSTRACT

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This paper explores the divergent effects of institutional reforms on firm's productivity and profits. To assess this empirically, we investigate the impact of various components of economic liberalisation on the performance of firms from Central and Eastern European countries from 1998 to 2006. The impact of reforms on profitability vis-à-vis productivity differs, which we interpret as an indication that profitability is an ambiguous measure of performance: one needs to distinguish between unproductive rents and productivity-based quasi-rents. We find that competition-enhancing liberalisation measures have more impact on state owned firms as compared with domestic and foreign owned firms. *Journal of Comparative Economics* **41** (2) (2013) 583–600. Aston University, Birmingham B4 7ET, United Kingdom.

1. Introduction

Following renewed interest in institutions (North, 1990; Crawford and Ostrom, 1995; Olson, 2000; Roland, 2000; Williamson, 2000 and many others), a wide literature has emerged since the mid 1990 which tests the impact of institutional quality on macroeconomic performance. In summary, this literature suggests a positive causal relationship between institutional reform and economic performance at the macro level (for meta-analyses see Babeckỳ and Campos, 2011; Efendic et al., 2011). Reforms are assumed to reduce transaction costs, investment risk and enhance business opportunities, generating greater returns to private sector investment and innovation (Ades and Di Tella, 1999; Dreher et al., 2007; Boerner and Hainz, 2009). Based on this, developing and transition countries are urged to improve their institutions and national governance structures. The expectation is that domestic industries will benefit in the long run, which will translate into increased economic growth. However, there is relatively little micro-level investigation of the perceived mechanisms linking reforms with firm behaviour and performance, less still that which examines the impacts on different types of firms. The large micro-literature has essentially focussed only on the link between change of ownership status (including transfer to foreign investors) and firm performance during a phase of institutional reforms (see Estrin et al., 2009 for overview). Yet this takes changes in the institutional environment as given: far less has been done on linkages between institutional reforms, ownership structures and performance. We intend to address these shortcomings, by taking a more complete view of the issue, combining

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effects of firms' ownership and market and institutional reforms in the analysis of firm performance. We highlight the importance of analyzing the differences both between firms and across countries, as well as the need to capture heterogeneity in the institutional environment. Following Krueger (1974), Ades and Di Tella (1999), and Dreher et al. (2007) we argue that restricting competition will lead some dominant players, including foreign firms, to capture significant market shares and generate high price–cost margins. Adopting this perspective, our contribution can be described as follows.

Firstly, as noted by Syverson (2011) we still know very little about the impact of institutions on firms' performance as the literature has been mostly silent on this. While our aim is to start filling this gap, we emphasise that in considering institutions, it is important not only to view institutional reforms as an aggregate concept, but also to analyse its multiple components separately, because each reform may have a different effect (Babeckỳ and Campos, 2011); we need to understand how particular elements of reform matter for performance. Accordingly, we account for heterogeneity across countries and across time in investigating the extent to which ownership, in conjunction with various institutional reforms explain both firm's productivity and profitability.

Secondly, having a large firm-level cross-country panel dataset, comprising of foreign, domestic and state-owned firms, we are able to control for location decisions of internationally mobile firms. Accordingly, we strengthen the existing literature methodologically by allowing for the sample selection effect. In particular, we argue that foreign ownership should not, as has been the case in much of the literature, merely be treated as an exogenous event. In the context of a study of institutional reform and performance, foreign direct investment (FDI) becomes an endogenous event.

Thirdly, apart from studies on regulated industries that seek to distinguish directly between efficiency-enhancing and rent-increasing effects (Saal and Parker, 2001; De Witte and Saal, 2010), much of the literature (perhaps rather erroneously) sees productivity and profitability as closely related. However, the distinction between productivity and profitability is an important one; Grifell-Tatjé and Lovell (1999) highlight the key differences between measures of productivity and profitability. This distinction is also discussed in a number of contexts related to our research question. For example, Girma et al. (2006) argue that productivity refers to the returns achieved by internal stakeholders, namely that increases in productivity boost discretionary resources potentially available to both the internal stakeholders ('the insiders') and the external stakeholders (in particular the shareholders and tax collectors). In contrast, profits represent only those returns that are available to external shareholders after internal stakeholders have taken their return. In particular, the shareholders benefit both directly from profits distributed as dividends and indirectly from retained profits that may increase the firm's net present value. We build on Girma et al. (2006), but also explain some limitations of their approach below.

Our dataset consists of a sample of 60,078 firms from 12 Central and Eastern European (CEE) countries, controlling for selectivity bias in ownership and analysing more closely the differential impact of various components of reforms. The countries we consider have all engaged in large scale institutional reform, but to different extents, albeit from a similar starting point. Thus, the CEE countries correspond to the 'natural experiment setting' (Eicher and Schreiber, 2010) as far as institutional reforms are concerned.[1]

The key intuition we wish to investigate empirically is that without reforms, incumbent firms realise high rents, resulting from obstacles to competition, which also leads to lower firm productivity (Krueger, 1974; Ades and Di Tella, 1999). We extend this line of research, by linking the institutional literature to that on effects of firm ownership. In particular, we posit that reforms may increase internal efficiency via enhancing the pressure of competition, facilitating access to new resources that come with lower transaction costs, and lowering agency costs, yet at the same time they may have an adverse effect on profitability. To the best of our knowledge this paper is the first to focus on these competing effects of institutional reform, across different types of firms.

In the next section we discuss our prior knowledge. Section 3 deals with sample and methods. Section 4 is on empirical results. We present conclusions in Section 5.

2. Institutional reforms, ownership and performance

2.1. Ownership

While we are mostly interested in how the interaction between macro level institutional reforms and micro-level ownership structures affect performance (see below), in this section we briefly discuss potential ownership effects on performance that may be independent from institutional variation (at least in the observed range of the latter).

Firstly, one strand of the literature explores whether acquisition by a foreign owned firm leads to productivity growth (Conyon et al., 2002; Harris and Robinson, 2002). The underlying assumption here is that foreign firms have some form of firm specific advantage, be it technical or managerial. When a host country firm is acquired by an inward investor, this knowledge or technology becomes available to the former, and productivity increases. This literature has expanded into analysis of ownership change in emerging and transition economies: the gains associated with resource transfers may be particularly significant in such environments (see Estrin et al., 2009 for a review). Thus, foreign owned firms may perform

[1] "The fall of the Iron Curtain provides a unique controlled, or natural, experiment in that the initial institutional change is clearly exogenous, which potentially mitigates the endogeneity bias. It also provides a unique opportunity to analyze the impact of subsequent structural policy changes/.../in a sizeable number of countries, with similar initial conditions, over the same period of time" (Eicher and Schreiber, 2010, p. 169).