



Are economic rents good for development? Evidence from the manufacturing sector

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ABSTRACT

Are rents, or excess profits, good for development? Rents could induce firms to lobby or bribe governments to preserve the status quo; on the other hand, rents may promote growth by giving firms the needed funds to make investments in fixed capital or research and development. To test this question empirically, we use a panel of manufacturing data at the industry-country-year level, and measure rents by the mark-up ratio. We find that the relationship between rents and growth is strongly negative, with the results being primarily driven by the poorer countries (or those with worse institutions) in the sample. This result holds when we instrument for mark-up using the average mark-up in other industries in the country. Even in industries with high external financing needs and countries with less developed financial sectors, precisely the places where excess profits could be used to drive growth, we find that rents are especially harmful. Consistent with the rent-seeking mechanism we highlight, we find that high rents are associated with a slower reduction in tariffs. We also test for the most likely alternative mechanism, that higher rents cause slower growth through the channel of allowing managerial slack. We find that controlling for management has little impact on our estimate of the impact of mark-up on productivity growth.

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“Without development there is no profit, without profit no development.” Joseph Schumpeter, *The Theory of Economic Development* (1934)

1. Introduction

Are rents, or excess profits, good for development?

We seek to answer this question by examining panel data at the industry level and applying analytical methods from the competition-and-growth literature (see [Aghion & Griffith, 2005](#)) to a larger group of countries along the development spectrum. Economic theory supports both sides of the argument, thereby offering conflicting advice for competition policy and anticorruption efforts. Surprisingly, there has been little statistical research in the last decade and a half since data availability has improved to increase the sample size by two orders of magnitude from earlier studies (e.g. [Ades & Di Tella, 1999](#)) and the theoretical debate has become more complex.

On the one hand, rents seem to be a compelling feature of successful economic development. “Schumpeterian rents” ([Galunic & Rodan, 1998](#)) can incentivize innovation and thus bring about the economic development Schumpeter was talking about, as the economy becomes more sophisticated and productive. “Without profit,” [Schumpeter \(1934\)](#) noted, “there would be no accumulation of wealth.”

A different view of rents and development can be found in [North, Wallis, and Weingast \(2009\)](#). North and co-authors argue that most societies in history—including today’s developing economies ([North, Wallis, Webb, & Weingast, 2007](#))—are “natural states” in which a dominant coalition of elites carve up the economy into protected rents that can be collectively enforced. As these natural states become more consolidated, elites have an interest to promote specialization and trade in order to increase the amount of rents at play (p. 49). By this mechanism, rents go part and parcel with political stability, and their presence is required if the economy is to develop.¹

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¹ Introducing an edited volume that applies [North et al. \(2009\)](#) to today’s developing countries, [North, Wallis, Webb, and Weingast \(2012\)](#) recognize that some rents might generate a drag on growth while others enable it, but they do not find a pattern across the case studies analyzed (p. 20).

A third idea can be found in the voluminous access-to-finance literature. Financial sector development is a key correlate of economic development (Levine, 1997). Countries with less developed financial sectors grow slower, all things equal. In those countries, retained earnings are an important source of capital for new investment. It thus seems logical that an economy or industry that enjoys higher profits or rents should be able to fund a faster expansion.

Taken together, these three conceptualizations highlight the crucial role for rents in economic development: as an incentive for innovation, a glue to keep elite interest in stability and expansion, and a source of capital for investment. Yet in spite of this logic there is a case to question the notion that high profits are good for economic development.

The strongest challenge to this notion is the flip side to North et al. (2009). Business interests can capture the state (e.g. Stigler, 1971), or vice versa (e.g. Shleifer & Vishny, 2002). Rents, rather than being used to promote growth, can be used to sustain the status quo, which is often one of limited competition. They can lead to corruption, since bureaucrats who preside over high-rent sectors will be able to extract more from the private sector (Ades & Di Tella, 1999). Rent-seeking activities exhibit increasing returns to scale, thus making rents self-sustaining, and because they are anti-innovation provide a further drag on growth (Murphy, Shleifer, & Vishny, 1993). Rent-seeking can draw talent from the productive sector (Acemoglu, 1995) and be destructive to entrepreneurship in particular (Baland & Francois, 2000).

The other first-order challenge to the view that rents are good for development is the flip side to Schumpeter. Rather than being an incentive for innovation, high profits may be a lack of incentive to do much at all—or, as Hicks (1935) said, “the best of all monopoly profits is a quiet life” (p. 8). If managers are not profit-maximizing and are lazily enjoying the rents from limited competition (e.g. Hart, 1983), then higher rents can lead to slower growth rather than more investment. Only when firms are at risk of losing their business are managers forced to innovate.

The impact of rents may vary depending on a country's wealth, as we illustrate with a simple example. Suppose a group of firms is locked in Cournot competition, and profits can be used for two purposes: socially beneficial research and development (via Schumpeterian creative destruction), and wasteful bribes to prevent new entrants (Stigler's “public choice” view). Credit constraints may limit the firms' spending (see Levine, 1997), but they can retain profits from previous periods. Firms spend on both categories, so factors that make bribery more attractive reduce the resources available for R&D, and vice versa.

There are two relevant differences between developing countries and wealthy countries. First, poor countries have weaker institutions (North & Thomas, 1973), so bribery is more common (Svensson, 2005). Second, financial systems are less well-developed, meaning that it is more difficult to access credit (Djankov, McLiesh, & Shleifer, 2007). The susceptibility of public officials to bribery means that resources will be drawn away from R&D, which suggests that rents are more damaging in poor countries. On the other hand, profits alleviate financial constraints more often in poor countries, so rents may provide the necessary funds for innovation. Thus, the relative impact of rents in poor countries may be more or less harmful, in addition to the ambiguity surrounding the overall impact of rents.

We address the question empirically, using the Lerner index as a measure of rents, following Nickell (1996), Aghion, Howitt, Griffith, Blundell, and Bloom (2005), and Aghion, Braun, and Fedderke (2008). The Lerner index (Lerner, 1934), also called a price-cost margin, is equal to the difference between price and marginal cost divided by price. Under perfect competition, price

should equal marginal cost giving a value of zero for the index. The greater the degree of monopoly pricing, the higher the index. In practice, marginal cost data are unavailable for large panel data applications, so mark-up is approximated using a variant of profits over revenues (Domowitz, Hubbard, & Petersen, 1986; Aghion et al., 2005). Since firm-level data in less-developed economies is spotty and unavailable in time series for most countries, we follow Aghion et al. (2008) and use industry-level value-added data from the United Nations Industrial Development Organization (UNIDO, 2013). UNIDO's INDSTAT data are available for 18 manufacturing sectors in over 100 countries between 1964 and 2009 (country coverage is described in Appendix A). The mark-up ratio we calculate is a measure of both rents and (lack of) competition (Clarke & Davies, 1982), and we do not make an attempt to separate these two concepts.

We supplement the UNIDO data on the mark-up ratio with other industry and national-level variables and empirically examine the questions laid out above. In contrast to the simple example of Cournot competition, where the relationship between profits and growth is unclear, our results are decidedly unambiguous. First, we find that observed rents are higher in less developed countries—virtually any indicator of underdevelopment is associated with a higher average mark-up in the manufacturing sectors. Second, we find that the relationship between rents and growth is strongly negative, with the results being primarily driven by the poorer countries (or those with worse institutions) in the sample. This result, that higher excess profits are correlated with slower growth in developing countries, is robust to a series of modifications to the specification including instrumenting for mark-up using the average mark-up in other industries in the country.

We then ask whether how the impact of mark-up changes with financial sector development (as measured by the level of domestic credit to firms relative to GDP) and the degree of external finance required by the industry (taken from Rajan & Zingales, 1998). If access-to-finance constraints are binding, then rents may be especially helpful to finance innovation in sectors that require external finance but in markets with weak financial sector development. In fact, we find that the effect of rents on growth is especially harmful in these situations. In other words, far from being a way to finance investment out of retained earnings, rents seem to be the key to limiting competition.

To be sure, there is potential for endogeneity in our specifications, as evidenced by an old literature seeking to predict mark-up, but most of the potential critiques work against our findings. If better-performing firms also acquire market share, then we should see a positive relationship between mark-up and growth (Demsetz, 1973). Or, similarly, if firms innovate in order to increase profits (Aghion & Howitt, 1992), then there should be a positive relationship between mark-up and growth. Since state-owned enterprises are important in developing countries, and they are on average less profitable and efficient than private firms (Boardman & Vining, 1989; Megginson & Netter, 2001), then we should see a more positive relationship (negative times negative) between mark-up and growth in developing economies. If firms in poor countries over-report costs or under-report profits, we should see less profit rather than more profits in developing economies. If high-growth industries are more profitable, then we should see a positive relationship between mark-up and growth. Some remaining critiques are dealt with by our use of multiple fixed effects specifications and instrumentation strategies.

At the level of the industry, our best measure of protection from “new entrants” is the level of tariffs. We look at the effect of mark-up on the change in tariffs, which of course have been on a secular decline over the period of the sample. As expected, the higher the

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