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The political economy of entry barriers[☆]

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ABSTRACT

We study a political economy model of entry barriers. Each period the policymaker determines whether to impose a high barrier to entry, and the special interest groups try to influence the policymaker's decision. Entry is accompanied by creative destruction—when many new firms enter, old firms are more likely to be driven out of the market. Therefore the current incumbents (industry leaders) tend to lobby for a higher entry barrier and potential entrants (industry followers) are likely to lobby for a freer environment for entry. We analyze both static and dynamic versions of the model to examine what kind of environment supports a policy that blocks entry. In the dynamic model, the economy can exhibit various different dynamics. In particular, multiple steady states may arise in equilibrium.

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1. Introduction

This paper studies a political economy model of entry barriers. We investigate the evolution of industries when incumbents lobby for high entry barriers in order to reduce firm turnover. The analysis of entry barriers has a long history in the industrial organization and the law and economics literature.¹ We focus on a particular subset of entry barriers—barriers that are imposed by government policies. Examples include legal procedures and monetary costs required when starting a new firm, documented by De Soto (1989, 2000) and Djankov et al. (2002).² Related to this, Rajan and Zingales (2003) argue that financial development in many countries has stagnated because large industry incumbents (and incumbent financiers) with political power opposed it in order to restrict competition. In their view, the industry incumbents want to keep financial costs high, so that the high costs can act as entry barriers. Another example is patent policy, which is often described to be influenced by lobbying.³ These policies change over time as the economy evolves, and analyzing these policy changes calls for a dynamic framework. In this paper, we take a particular policy determination rule (a lobbying game by special interest groups) as given, and analyze how policies regarding entry barriers change over time as the economy evolves.

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¹ See, for example, McAfee et al. (2004) for the history of concepts. Tirole (1988, Chapter 8) is the textbook treatment of the entry and exit behavior in industrial organization literature.

² The World Bank provides more recent updates (see <http://www.doingbusiness.org/>). It documents entry barriers such as entry fees, procedures to obtain permits, requirements for government-provided licenses, and minimum capital requirements.

³ See Boldrin and Levine (2008) for various episodes.

Many recent studies in the industrial organization literature suggest that the entry process contributes significantly to an industry's productivity growth. As an extreme example, Foster et al. (2006) find that almost all the labor productivity growth in the U.S. retail trade sector in the 1990s is accounted for by more productive entering establishments replacing less productive exiting establishments.⁴ In macroeconomics, the process of creative destruction has been at the center of the endogenous growth literature.⁵ Recent model-based macroeconomic studies also deliver similar messages: Barseghyan and DiCecio (2011) and Moscoso Boedo and Mukoyama (2012) suggest that high entry costs contribute significantly to lowering productivity in poor countries.

This paper builds a simple political economy model of policy choice in an economy that is characterized by creative destruction. In building our model, we draw our inspiration from Olson (1982). Analyzing the behavior of special interest groups, he argues that "It would be in the interest of these groups that are organized to increase their own gains... This would include choosing policies that, though inefficient for the society as a whole, were advantageous for the organized groups because the costs of the policies fell disproportionately on the unorganized" (p. 37). As a result, a socially undesirable policy can be chosen due to the influence of the special interest groups. We model the determination of the policy on firm entry regulations as a special case of his analysis. In our model, there are two special interest groups, or "coalitions," who typically have opposite policy preferences. One is the group of incumbent firms who do not want to be driven out of the market by new entrants, and thus favor a policy that makes entry difficult. The other is the group of the potential entrant firms who want a policy that allows them to enter easily. We do not model consumers—they are "the unorganized" who suffer from the cost of low productivity or lack of new products when a policy that is detrimental to new entry is selected.⁶

A recent work by Acemoglu and Robinson (2012) expresses a related view. They argue that a society which is ruled by a narrow elite who pursue their own benefit at the expense of the mass of the people tends to stagnate. They call such an organization (rules) of society "extractive institutions." It is contrasted with "inclusive institutions," which allow the participation of the mass of the people in economic activities. Inclusive institutions tend to promote entry of new businesses and creative destruction, while under extractive institutions, innovative new technologies are often blocked due to political opposition. They write "The fact that they [the elites] have much to lose from creative destruction means not only that they will not be the ones introducing new innovations but also that they will often resist and try to stop such innovations" (pp. 183–184). Furthermore, similarly to our own view, they emphasize the role of organized groups: "It is also necessary to consider more broadly the factors that determine how political power is distributed in society, particularly the ability of different groups to act collectively to pursue their objectives or to stop other people from pursuing theirs" (pp. 42–43).

The contribution of our paper is to propose a tractable model that treats both the distribution of political power and the policy regime as fully endogenous and dynamic (while treating the nature of the political process as given). We highlight the utility of this framework in two cases. First and most importantly, under some parameter values there are two possible long-run steady states: one with low incumbent power and lots of entry and exit and another with high degree of incumbent power and little turnover. This is a potential explanation for the observed variety of entry regulations around the world. Second, we show that for some parameter values the political power of incumbents increases over time, which leads to economic policies more favorable to existing firms, reinforcing the process. Under this situation, even an economy with a large amount of entry can eventually switch to a regime with high barriers to entry and little turnover, similarly to the postwar experience of the economy of the United Kingdom.

We build on the framework of menu auctions by Bernheim and Whinston (1986) to model the policy determination in an environment with special interest groups. In characterizing our model, we utilize Bergemann and Välimäki's (2003) dynamic extension of Bernheim and Whinston (1986). The menu auction framework is widely used in the context of international trade policy—for example, in Grossman and Helpman (1994), special interest groups lobby for trade policies. In this paper, we start from a static model that is a direct application of the Bernheim and Whinston (1986) framework, and then contrast the results with the dynamic model. In applying Bergemann and Välimäki's (2003) results, we have to make modifications due to the difference in settings. In particular, in our model, the state space is continuous. In Appendix C, we show the existence of an equilibrium in a discrete-state setting and then show that it converges to the equilibrium with continuous state space by making the state space finer and finer. While this extension may be of independent interest, we emphasize that our main contribution is the *application* of the theory of menu auctions to our specific context rather than the development of the tool.

There are some other recent studies that are influenced by Olson's work. Krusell and Ríos-Rull (1996) consider a model where agents vote on the adoption of new technology. While young agents like the new technology, older agents who have a

⁴ Using the Census of Manufactures data, Foster et al. (2001, Table 8.4) attribute about half of the multifactor productivity growth in the U.S. manufacturing sector during 1977–1987 to the reallocation of production resources across plants. In particular, 26% of productivity growth is due to the entry and exit of plants during this 10 year period.

⁵ See, for example, Grossman and Helpman (1991) and Aghion and Howitt (1992). Parente and Prescott (1999) also share our view that the entry of new firms with new technology is essential in growth and development and thus barriers to entry can cause stagnation. Although our model in the main text does not have endogenous growth, Appendix A presents a version of our model with general equilibrium and endogenous growth. There we show that inhibiting creative destruction results in some welfare costs. Note that in the context of the innovation-based growth models, it is not always the case that promoting entry (by weakening the patent policy or providing entry subsidies) enhances growth, because monopoly rights can provide incentives for innovation. See, for example, Mukoyama (2003) and Aghion et al. (2005) for detailed discussions. The implications for welfare is also complex, since these endogenous growth models typically involve both static and dynamic distortions.

⁶ The growth model in Appendix A explicitly considers consumers and their welfare.

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