RESEARCH BRIEF

Connecting to Power: Political Connections, Innovation, and Firm Dynamics

Based on BFI Working Paper No. 2018-72, "Connecting to Power: Political Connections, Innovation, and Firm Dynamics," by Ufuk Akcigit, associate professor, University of Chicago; Salome Baslandze, assistant professor, Einaudi Institute for Economics and Finance; and Francesca Lotti, Bank of Italy

KEY TAKEAWAYS

- ✓ Firms can stifle competition by out-competing new firms or preventing their entry into a market
- ✓ In Italy, new data reveals that large and old firms leverage local political connections to reduce competition
- ✓ These politically connected firms hire more workers and earn more revenues, but at the cost of lower productivity and reduced benefits for the whole economy
- ✓ In markets where local political connections are widespread, firms that support losing candidates grow more slowly and exit more quickly

In a textbook economy, when a firm gains market power it works hard to innovate and increase productivity so that it can fend off new and existing challengers. This competition results in a churning of firms and workers that, over the long term, means higher profits for firms and incomes for workers, as well as better products for consumers.

In reality, not all firms respond to competition in textbook fashion. Rather than work to outcompete challengers, firms in some markets engage in behavior meant to limit the entrance of new competitors and to restrict the growth of existing competitors. This stifles innovation and productivity growth and mutes the returns to firms and workers. One of the most efficient means of restricting competition is to curry the favor of local politicians.

In "Connecting to Power: Political Connections, Innovation, and Firm Dynamics," Ufuk Akcigit, UChicago associate professor, Salome Baslandze, assistant professor at Einaudi Institute for Economics and Finance, and Francesca Lotti of the Bank of Italy, reveal how the employment of local politicians in Italy benefits firms and helps secure their market positions. Their insights, based on a new and extensive dataset, raise questions for markets beyond Italy—including the United States—where big firms are growing and capturing larger amounts of market share.

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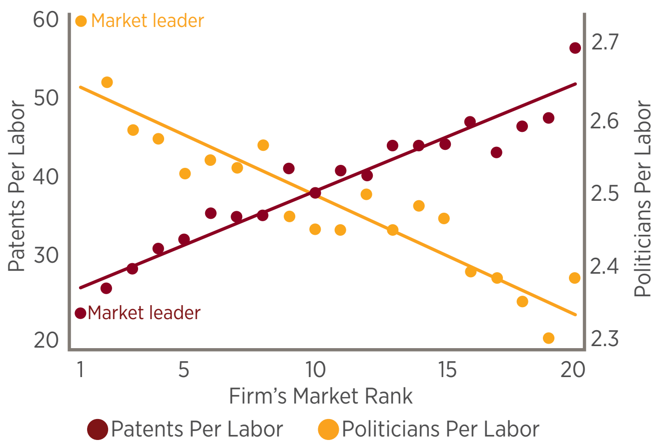
Figure 1: Leadership Paradox: Market Rank, Innovation, and Political Connection



Eight facts about the politics of business

Before describing the authors' findings about local political connections and firm behavior, it is worth noting that their analysis is based on a detailed, large-scale micro dataset from 1993-2014 that merges firm-level balance sheet data, social security data on the universe of workers, patent data from the European Patent Office, the registry of local politicians, and detailed data on local elections in Italy. These data allow the authors to exploit the differences in the type of political connections, based on the level or the rank of a position, or party affiliation of a politician employed.

Importantly, the authors focus on local politicians at the municipality, province, and regional level. Most existing research on this subject focuses on high-profile connections such as parliament members; however, low-profile connections are much more prevalent and those politicians hold sway over such factors as the provision of public services, issuance of permits and licenses, and the application of administrative burden. The authors' unique dataset allows them to examine how firms change their competition strategy as they gain market power, revealing what firm-level outcomes are associated with (or implied by) political connections.

For purposes of their work, the authors define local political connection as when an individual holds a local political seat (like mayor or city council member), and also has a job in private industry. The authors' analysis reveals eight facts, briefly described here and at greater length in the full working paper, that reveal the influence of local political connections on Italian firm behavior in the private sector:

Fact 1: Firm-level political connections are widespread, especially among large and old firms.

Large firms have much to gain through political connections, in terms of protecting their market share. And since it takes time to build those connections and to align with winning candidates and parties, older firms are often well connected. In Italy, while the average share of connected firms by industries is around 4.5 percent, connected firms account for 33.6 percent of employment across industries. Further, 45 percent of firms with more than 100 workers are politically connected.

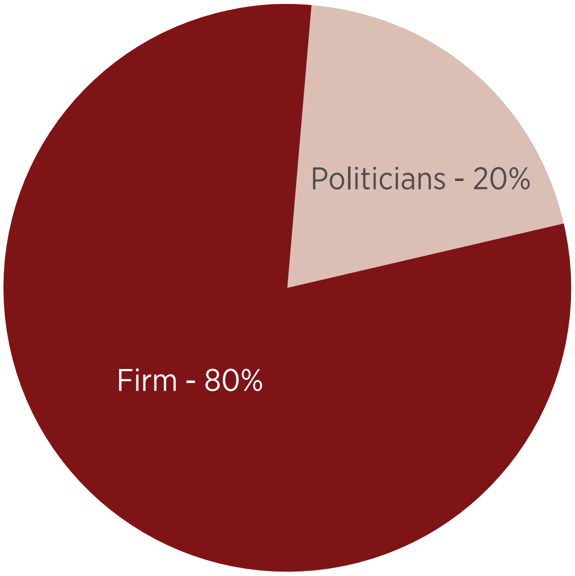
Fact 2: More connected industries face lower firm entry, but conditional on entry, entrants are more likely to be connected than in other industries.

Industries with more political connections are less dynamic (not as much entry and exit as otherwise), and incumbents in these industries are larger, on average. Entrants might seek political protection before entering a market. Consequently, connected industries have fewer young and small firms and, therefore, do not benefit from the innovation that these firms typically bring.

Fact 3: Industries with higher share of politically connected firms have a lower share of young firms and show lower growth and productivity.

Following from the first two facts, the third result shows that industries with higher political presence grow less, on average, and are less productive. Most of this negative relationship stems from the fact that more connected industries are dominated by large and old firms.

Figure 2: Rent Sharing Between Firm and Politician



Notes: Back of the envelope calculation for the rent division between a firm and politicians. Total rent consists of firm's yearly profit gain from connections (dark red area) and an additional yearly income gain for worker-politicians attributed solely to their political status (light red area). See the main text for the details of the calculation.

Fact 4: Market leaders are most politically connected but are least innovation intensive, relative to their direct competitors.

This is a key finding of the authors' analysis. As a firm starts to dominate a market, the firm changes its business strategy from innovation to influence-seeking (known as rent-seeking). Across markets, the authors chart the number of politicians per 100 white-collar employees. As firms get larger they become more politically connected; at the same time, these firms become less innovation intensive. (See Figure 1.)

These results for Italy are consistent with earlier findings on U.S. firms[1], which show that larger firms are less innovation-intensive and develop less impactful technologies. In this regard, an observation that large Italian firms and market leaders are less innovative is perhaps expected; however, the key finding in this research is that these firms rely more on political connections to maintain their advantage.

Fact 5: Politically connected firms are less likely to exit, conditional on other observables.

Not only are politically connected firms less likely to exit, but their survival probability increases with the value of their political connection: higher-ranking politicians on a firm's payroll mean more success for that firm.

Fact 6: At the firm level, political connections are associated with higher employment and revenue growth but not with productivity growth.

Politically connected firms may hire more workers and earn more income, since they are typically growing more than their competitors, but this growth is not associated with gains in productivity. So, while on the one hand this employment growth may seem good for a few large firms and those who work for them, on the other hand this employment growth is limited to those few firms. Further, since this growth comes without increases in productivity, society will benefit less from it.

Fact 7: Firms supporting losing parties in close elections grow much more slowly.

Imagine a close election featuring Party A and Party B, for instance, where each could possibly win. It's a toss-up. In a healthy economy, it should not matter if a firm favors Party A or Party B, or employs principals from either party: the election is determined by a very small margin—almost by chance—and business should continue as before. However, the authors find that firms supporting the losing party grow more slowly compared to those who support the winning party. In this case, the age or size of a firm is no protection against this phenomenon.

> As a firm starts to dominate a market it changes its business strategy from innovation to influence-seeking.

[1] *Akcigit, Ufuk and William R. Kerr, "Growth through Heterogeneous Innovations," Journal of Political Economy, 2018, 126(4): 1374-1443.*

Fact 8: Politically connected firms capture 80 percent of increased surplus, while politicians capture the remaining 20 percent.

Of those surplus gains attributed to political connections, the politicians employed by politically connected firms take home 20 percent of increased surplus, while the firm retains the rest. (See Figure 2.)

Conclusion

The authors employ a unique and powerful data set that allows them to determine not only the number of local Italian politicians that are employed in various firms, but also those employees' positions and salaries. These data, among others, allow them to reveal relationships between local political connections and the success of firms. At a macro level, their description of how such rent-seeking can dampen productivity in may, at least partially, explain the reduction in Italian productivity from 1993-2014.

More broadly, the authors analysis should give pause to policymakers in countries with increasing market concentration among a few large firms, including the United States and other countries, where such firms may seek to stifle competitors through rent-seeking rather than technological progress. In such cases, this work suggests, it behooves policymakers to understand the role of local political connections in the economy.

CLOSING TAKEAWAY

This analysis should give pause to policymakers in countries with increasing market concentration among a few large firms, and behooves policymakers to understand the role of local political connections in the economy.

READ THE WORKING PAPER

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