

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

Akcigit, Baslandze, & Lotti (NBER WP #25136)

Levi Crews (Chicago)

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Introduction

- **motivation:**
 - factor reallocation is an important source of growth
 - political lobbying/corruption can cause misallocation
- **question:** do political connections affect firm dynamics, innovation, and creative destruction?
- **answer:** **YES!**
- **potential mechanism:** political connections ...

eliminate MC wedge vs. reduce entry/exit
static gain dynamic loss

- **today:** recap empirical facts, sketch mechanism

Empirical facts: Political connections \Rightarrow Firm dynamics & Innovation

new data: Italian firms, workers, elections (1993-2014)

- firm-level balance sheets
- social security data on universe of workers, firms
- patents
- registry of local politicians
- elections data

connected \iff employ \geq 1 politician

1. firm-level political connections are **widespread**, especially among large (and old) firms
2. industries with larger share of politically-connected firms feature **worse firm dynamics**
3. **market leaders:** more likely **connected**, less likely to **innovate**
4. connections \approx higher survival, higher empl & rev growth, **not higher LP**

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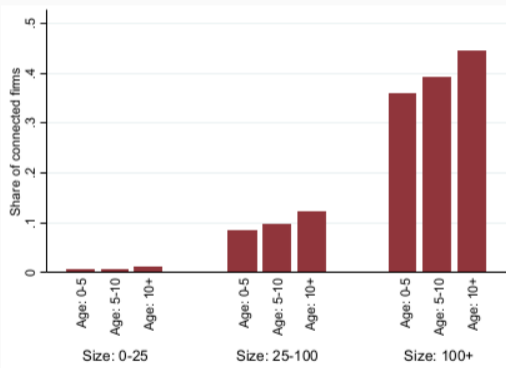
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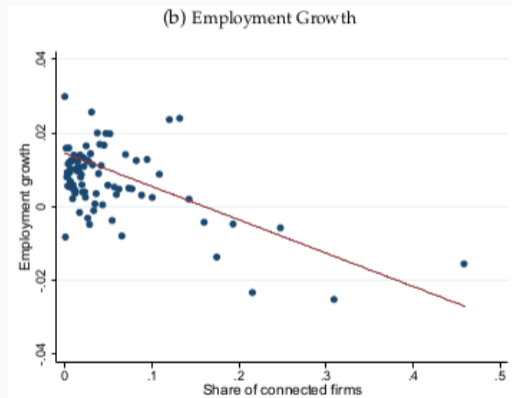
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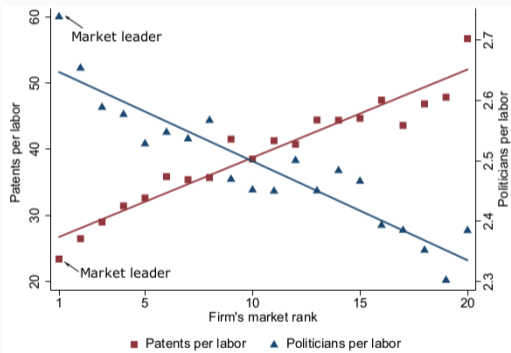
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	Empl growth (OLS)	VA growth (OLS)	LP growth (OLS)
Connection	0.032*** (0.001)	0.039*** (0.002)	-0.014*** (0.002)
Connection major	0.003* (0.001)	0.010*** (0.002)	-0.001 (0.002)
Log Assets	0.065*** (0.000)	0.036*** (0.000)	-0.028*** (0.000)
Log Size	-0.077*** (0.000)	-0.080*** (0.000)	0.021*** (0.000)
Age	-0.002*** (0.000)	-0.004*** (0.000)	-0.001*** (0.000)
Year FE	YES	YES	YES
Region FE	YES	YES	YES
Industry FE	YES	YES	YES
Firm FE	NO	NO	NO
Observations	6,545,131	5,684,519	5,598,367

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(Potential) Mechanism: static gain \implies dynamic loss

model: quality ladder + MC wedge

- **extra choice:** pay fixed cost of “connecting” to eliminate wedge (“red tape”)
 - incumbents can connect more easily than entrants
- **cutoff rule:** only high-quality firms connect (endogenously)
 - higher variable profits without wedge \implies connected firms grow in employment, revenue
 - cutoff internalizes that connection discourages entry

