The politics of entry

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Introduction and summary

Entry is an underresearched topic in economics. In this thesis we investigate how politics, defined as political preferences and executive contraints, shape the level and composition of entry. The number and identity of entrepreneurs is influenced by political choices over licenses, subsidies or the distribution of loans. This capability to direct market access puts politicians at the heart of a struggle between citizens for preferential market access to a protected market. Interest groups form to enable citizens to jointly offer political contributions in exchange for preferential access. The effectiveness of these offers depends on the political influence of consumers who suffer from reduced production. Their political influence is determined by the level of political accountability, reflecting the ability of citizens to question and challenge government policy. This thesis studies three distinct cases of this struggle using a single political economy framework. Before summarising the three main chapters, we shortly review evidence showing that politicians influence market access to their advantage.

1.1 The link between politics and entry

Politicians affect entry by with-holding licenses or by drafting more general legislation that impedes entry (De Soto, 1990). The public interest view argues that the government may screen entrants and effectively restrict entry to correct market failures such as low quality products, negative externalities, duplicated effort or instability stemming from low profit margins and/or herding. By correcting market failures, stricter regulation of entry induces greater social welfare. Alternatively, regulation may be acquired by industry. Here, stricter regulation of entry keeps competitors at bay and protects incumbents' rents. It may also be the case that government officials set up a 'tollbooth' by erecting high official entry barriers to be bribed by those trying to overcome these barriers. For example, potential entrants may bribe the official not to screen or to conceal the information gained (Guriev, 2004). These dealings between industry and politicians are described by the private interest view that argues that stricter regulation generates rents for industry and political leaders, and damages social welfare. Empirical evidence strongly supports the private interest view. Countries in which government faces greater democratic control, and thus serves the voters' interest better, have lower barriers to entry. For example, countries with more democratic and limited governments have lighter regulation of entry comprising the number of procedures, official time, and official start-up costs before a business can operate legally (Djankov, La Porta, Lopez-de-Silanes and Shleifer, 2002). When citizens have greater democratic rights competition is more fierce (Benmelech and Moskowitz, 2008) and firms are younger and more innovative (Acemoglu, Aghion and Zilibotti, 2006). A more efficient, independent and trusted legal system also constrains the executive and enhances growth and access to finance by small firms (Frye and Shleifer, 1997; Beck, Demirgüç-Kunt, Laeven and Levine, 2008). In general, regulatory capture is deeper when a small elite enjoys weak competition (Engerman and Sokoloff, 2002; Acemoglu, Johnson and Mitton, 2007).

An important way for politicians to control entry is by influencing access to finance. Such political influence on lending may be direct through state banks or indirect through regulation of private banks. State banks favour politically connected firms which receive larger loans and pay comparable interest rates to non-connected firms, even though they are less likely to repay (Khwaja and Mian, 2005; Faccio, 2006 ; Claessens, Feijen and Laeven 2007). In addition, interest rates on Italian state bank lending are lower for larger firms and in areas where the political party affiliated to the bank is strong (Sapienza, 2004). Privatization of banks reduces political interference (Shleifer and Vishny, 1994; Bennedsen, 2000; Martimort, 2005), yet the privatization decision itself is an endogenous political choice. When banks are privately owned, politicians still influence access to finance and stability indirectly through regulatory choices. Special interests lobby to for regulation that limits competition, allows captured access to finance and undermines newcomers (Kroszner and Strahan, 1999; Rajan and Zingales, 2003). Insiders may also lobby to weaken minority investor rights to protect private benefits (Bebchuk and Neeman, 2009), which has the effect of reducing access to finance for other firms. In line with the evidence on entry regulation, a highly accountable democracy with diffused media circulation stimulates financial access and entry (Perotti and Volpin, 2007). In addition, a remarkable panel study of United States states shows that regulation favorable to access to finance and entry is strongly associated with stronger political and suffrage rights (Benmelech and Moskowitz, 2007). Finally, former high-ranking politicians are more likely to become bank directors in countries with more powerful but less accountable governments. When more of such connections exist, bank regulation tends to be more pro-banker (Braun and Raddatz, 2010).

The abuse of political control over entry is more intense when the executive is relatively unconstrained. In Burundi licensing and access to finance were manipulated by politicians to favour core constituents (Ngaruko and Nkurunziza , 2002). In Mali the executive created rents through political case-by-case control of entry in both the industrial and trading sector, which was only reduced due to public protests leading to regime change and a freer press (Daubrée and Stavasage, 1998).

1.2 Modeling Institutions

A government should seek to maximise social welfare. Even if the social welfare is clearly defined and there is agreement on how to maximise it, governments do not always pursue this social obligation. Schumpeter (1950) already states that "It does not follow that the social meaning of a type of activity will necessarily provide the motive power". In more recent years the well-known public interest view has been proven wrong on many occasions, such as for the regulation of entry in Djankov, La Porta, Lopez-de-Silanes and Shleifer (2002). Politicians' fulfillment of their social obligation only comes as a 'by-product' of serving their own interests such as income, power and the status attained by being in office, see Downs (1957). Therefore, by controlling access to income, power and office citizens can incentivise politicians to serve their interest. To gain such control citizens need to be able to solve their collective action problem via mass protest, the media or elections. We capture the overall ability of citizens to observe and direct political decisions towards social welfare in a single variable, political accountability. In this thesis a country's level of political accountability is the exogenous institution driving many of the results. When modeling it formally, accountability is defined as the weight politicians puts on citizens' welfare relative to his own.[1] This means that when accountability is zero politicians maximize their own consumption, while higher

[1] The specific functional form is irrelevant, as long as the politician cares more for social welfare relative to his own as accountability goes up.

accountability forces politicians to take consumption of citizens into account too. So, as accountability increases politicians are more sensitive to public opinion; they need to provide higher social welfare to stay in power. Analysing how accountability is determined is outside the scope of this thesis. The focus is on the political incentives that different levels of accountability generate. Using the reduced form allows us to rank countries along single aggregate measures and to perform relatively simple tests for the models' predictions. Crucial for this approach is that accountability can neither be reduced to zero by politicians nor increased to the maximum by citizens. It is reassuring that countries today span a wide range from low to high accountability and that accountability is (somewhat) persistent. Next to political accountability we introduce judicial independence (legality) in chapter two and polarisation in chapter four as distinct institutional variables. Legality constrains the executive in breaking the law, in our case accepting bribes. It refers to the willingness and ability of the judiciary to prosecute and condemn politicians for accepting bribes. Polarisation refers to the leadership's valuation of the utility from their community's members relative to the utility of other citizens. It thus represents the depth of existing social divisions. When modeling we assume that legality and polarisation are deeprooted institutions that remain unaffected by politicians and citizens.[2] So, in this setup institutions affect political preferences and thus political action while political action does not affect institutions.

1.3 The model's assumptions

Throughout this thesis we use the same setup which we shortly describe in the next paragraph. Here we emphasize the simplifying assumptions we make which help us to reduce complexity and focus on interest group formation, entry and stability. The

[2]Countries may have high legality and low political accountability such as Singapore and the reverse such as the Philippines. Countries may also have high polarisation and high political accountability such as Belgium and the reverse such as North Korea

tailoring of the chosen setup to specific questions is presented in modeling sections of the corresponding chapters.

We study *a single politician* holding the power to regulate entry into a market for final goods. A unit mass of citizens consumes this final good while *every citizen has sufficient disposable income to buy the optimal amount of final goods.* In pursuit of noncompetitive profits each citizen tries to convince the politician to grant him exclusive market access. Access to the protected market enables any citizen to start *a firm producing a single unit of final good*, and to generate profits. To influence the politician more effectively *citizens may join a single interest group* offering political contributions to the politician under the assumption that *interest groups can commit to paying contributions after the politician has delivered upon the agreed policy.* We abstract from collective action problems within interest groups, as *contributions are shared equally by the winning group's members.* The politician compares the offers, meaning that *the politician treats all contributions equally, irrespective of their form or origin*[3]. The politician then sets entry optimally and those citizens satisfying the political entry requirements start a firm, produce, sell the final good and pay political contributions.

1.4 Thesis overview

This thesis contains three self-contained chapters which can be read independently, each with its own introduction, analysis and conclusions. A full list of variables and references can be found at the end of the thesis. Although all chapters discuss political influence over entry using the same basic theoretical framework, each has a distinct focus. Chapter two and three were written with my supervisor, Enrico Perotti. All remaining errors are mine.

[3]As will become clear, the politician may receive bribes or lobbying contributions in chapter two, may be paid for direct provision of loans or a bank charter in chapter three and receives contributions from different segments of the population in chapter four.

We investigate differences in interest group formation under bribing and lobbying in chapter two, bank control, access to finance and financial stability in chapter three and discriminatory entry in a divided society in chapter four.

1.4.1 To be bribed or lobbied

Chapter two focuses on the choice of a politician to not enforce any rule, control entry directly and collect illegal bribes *or* commit to a rule, control entry indirectly via this rule and be legally lobbied. Ours is the first paper investigating the effects of either acquiring an individual exception to a rule (bribing) and changing a rule applicable to everyone (lobbying) on the formation of interest groups. We show how controlling entry directly generates lower entry rates and grants politicians more bargaining power, as no interest group has a strategic advantage in the lobbying game. Using a rule namely creates a cut-off creating a free riding advantage for citizens with characteristics favoured by the rule. By forming a separate interest group 'the strongest' citizens are able to reduce competition from other groups, which is impossible when the entry rule is not enforced. Despite generating lower rents, the illegality of bribes induces politicians to switch to regulation when political accountability is high. As a result, countries with weak accountability are characterised by bribing and relatively low entry while countries with strong accountability exhibit lobbying and higher entry rates. We demonstrate empirically that additional executive constraints result in fewer and faster procedures to set up a new business, facilitating entry.

1.4.2 Bank ownership and financial stability

In chapter three we study another political choice between state, captured private or diffusely held private banks. Under state-ownership citizens pay the politician for exclusive access to loans. When banks are private, citizens pay the politician for a bank charter. Under both ownership types the party in control decides on whom to grant a loan and on the intensity of monitoring, which determines how much of the loan is repaid. This paper's contribution is to endogenously model such bank control and to investigate its effects on financial stability and entry in the product market. We show that when accountability is low, politicians prefer state control to maximize their rents. As state banks are less efficient, there is a shift to private control for higher accountability. This transition leads to higher risk taking, as private banks do not internalize the social costs of bank failure. To discourage private risk taking more effectively, the politician leaves more rents to private banks which then have more to lose in case of default. We conclude with some suggestive data linking bank control to accountability, complementing existing evidence that financial instability is highest when banks are private and captured by a small interest group.

1.4.3 Partisan entry

In countries where the population is segmented by ethnic, language or other ex ante traits politicians may cater to core constituents by favouring their entry independent of their efficiencv. Chapter four investigates how political accountability and polarisation between communities affect such targeted entry. It provides a framework rationalising the observation that inequality and conflict are often prevalent in (transition) countries with intermediate accountability. The model shows that ownership is most targeted when polarisation is high and when political accountability is *intermediate*. To get an intuition for the second result consider two extremes: zero and perfect political accountability. When accountability is zero the politician seeks to maximise total firm profits to enlarge political contributions by allowing entry to a small but efficient set of entrepreneurs. When accountability is perfect the politician maximises production by allowing free and therefore efficient entry. Hence, entry is nondiscriminatory in both extremes. Only when accountability is intermediate and efficiency considerations do not dominate the politician's decisions, entry is limited and biased. We also show that a more polarised society induces discriminatory entry and inefficient production, resulting in lower total entry.