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Incumbents and protectionism: The political economy of foreign entry liberalization ☆

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Abstract

This paper investigates the influence of incumbent firms on the decision to allow foreign direct investment into an industry. Using data from India's economic reforms, the results show that firms in concentrated industries are more successful at preventing foreign entry, state-owned firms are more successful at stopping foreign entry than privately-owned firms, and profitable state-owned firms are more successful at stopping foreign entry than unprofitable state-owned firms. The pattern of foreign entry liberalization supports the private interest view of policy implementation and suggests that it may be necessary to reduce the influence of state-owned firms to optimally enact reforms.
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1. Introduction

Liberalizing international capital flows can increase economic growth (Bekaert, Harvey, and Lundblad, 2005). Yet, many countries restrict inflows of foreign investment. Recent evidence suggests that incumbent firms that receive preferential treatment may oppose policy changes that threaten their favored status.[1] In particular, Rajan and Zingales (2003a, 2003b) and Stulz (2005) argue that entrenched incumbent firms have an

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[1]The evidence suggests that (1) banking deregulation is delayed in U.S. states where incumbent banks have the most to lose from entry (Kroszner and Strahan, 1999); (2) entrenched firms lobby to restrict access to credit after a crisis, forcing poorer entrepreneurs to exit

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incentive to oppose the liberalization of international capital flows if liberalization limits their ability to extract monopoly rents. This paper investigates incumbent firm influence on the decision to liberalize foreign direct investment.

Specifically, we examine the Indian government's decision to selectively reduce foreign direct investment barriers in a subset of industries after a balance-of-payments crisis in 1991. The corporate sector in India is characterized by the concentrated control of assets by state- and family-owned firms, much like in the rest of the world (La Porta, Lopez de Silanes, Shleifer, and Vishny, 1999). We adopt a political economy approach to ask the following questions: Did incumbent firms influence the government's decision to liberalize foreign direct investment in some industries and not others? If so, which incumbent firms had the most to lose from foreign entry and the ability to oppose it?

To investigate these issues, we use a rich firm-level data set that provides detailed balance sheet and ownership information for more than 2,100 firms that account for over 70% of India's industrial output. The data are classified into state-owned, group-owned, and privately owned firms. We investigate whether pre-liberalization characteristics such as industry structure and the ownership of incumbent firms can explain the government's decision to selectively open some industries to foreign entry.

The private interest and public interest views of policymaking suggest possible explanations for the government's decision to liberalize some industries and not others. The private interest view characterizes the policy process as one in which special interest groups lobby the government to influence policy decisions in their favor, which may result in non-welfare-maximizing outcomes (Olson, 1965; Peltzman, 1976; Becker, 1983). The public interest view assumes that governments enact welfare-maximizing policy changes to achieve socially efficient outcomes and correct market failures, without regard for private interests (Joskow and Noll, 1981).

Using data on industry structure and firm characteristics, we investigate whether the government randomly liberalized industries, or whether the private or the public interest views better explain the pattern of liberalization. For instance, the private interest view holds that the probability of foreign entry liberalization will be inversely related to industry concentration. Incumbent firms in these industries have a greater ability to lobby the government and prevent policy changes, such as foreign entry, that could adversely affect them (Olson, 1965; Stigler, 1971; Peltzman, 1976). Further, incumbent firms in profitable concentrated industries have a greater incentive to prevent entry in order to protect their monopoly profits (Stigler, 1971). In contrast, from a public interest perspective the government would liberalize entry to reduce deadweight losses in concentrated industries that earn monopoly profits (Pigou, 1938).

The government also may be more receptive to the interests of particular incumbents, such as state-owned firms that occupy a prominent position in many economies around the world (Megginson, 2005). Indian state-owned firms account for over 40% of the total capital stock in the economy (Gupta, 2005). Politicians obtain private benefits from state-owned firms, such as the ability to hire surplus workers (Shleifer and Vishny, 1994). Moreover, the earnings of state-owned firms directly accrue to the government. Therefore, policy makers may have an incentive to protect industries with large or profitable state-owned firms from competition.

Our main results are as follows. First, consistent with the private interest view, the likelihood of foreign entry liberalization in an industry is inversely related to its concentration. On average, the probability of liberalization decreases by 27% for a one-standard deviation increase in the Herfindahl index from its sample mean of 0.45.[2] Second, consistent with the hypothesis that firms in concentrated industries have an incentive to protect their monopoly profits, the likelihood of foreign entry liberalization is significantly lower for profitable, concentrated industries. Third, regional variation in firm location reveals a negative and significant relationship between geographic concentration and the likelihood of foreign entry liberalization.

Fourth, the results show that industries with a sizable state-owned firm presence are significantly less likely to be liberalized. Whereas industries with state-owned monopolies face a 14% chance of being liberalized,

(*footnote continued*)
(Feijen and Perotti, 2005); and (3) post-1500, Western European countries with monarchies opposed free entry in profitable industries (Acemoglu, Johnson, and Robinson, 2005).

[2]The Herfindahl index is an indicator of the degree of competition among firms in an industry. It is defined as the sum of the squares of the market shares of each firm in an industry. The value of the Herfindahl index can range from zero in perfectly competitive industries to one in single-producer monopolies.

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