

# Financial Frictions, Market Power, and Innovation

Pedro Armada

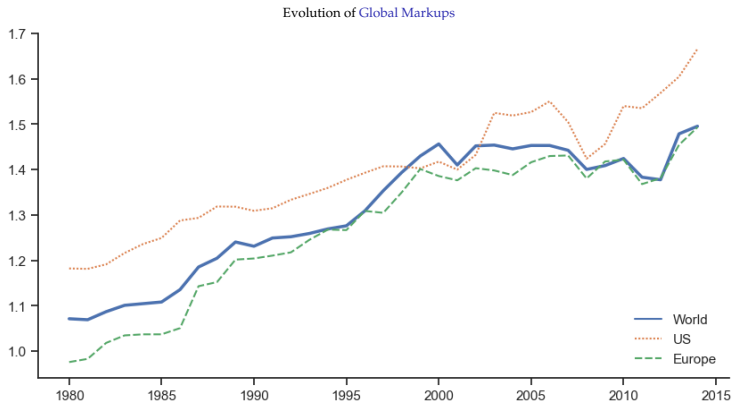
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# Introduction

- ▶ Key indicators of **market power** are rising across many industries in the U.S. and Europe. (De Loecker et al., 2020; De Loecker and Eeckhout, 2018; Akcigit et al., 2021)



*Notes:* The markup is the sales-weighted average of all firms' individual markup in the geographical region in a given year. *Sources:* De Loecker et al. (2020) for the U.S., and De Loecker and Eeckhout (2018) for the World and Europe.

# Introduction

- ▶ In addition to raising prices for consumers and limiting job opportunities for workers, growing market power also hinders **innovation**, a crucial driver of long-term economic growth.
- ▶ Since rising market power has mostly been observed among large publicly listed firms (De Loecker et al., 2020; Diez et al., 2021), which tend to have better access to external funding (Dinlersoz et al., 2019), an important question is whether and how **financial frictions** and **market power** interact in shaping firms' incentives to innovate.
- ▶ In this paper, I ask:
  - ▶ How does the economy's competitive structure affect innovation when firms are financially constrained?
  - ▶ What role does financial development play in influencing the impact of competition policies?

# This Paper

- ▶ Novel quantitative framework that bridges two strands of literature:

- ▶ Macroeconomic impact of financial frictions:

Buera et al. (2011), Midrigan and Xu (2014), Moll (2014), Gopinath et al. (2017), Itskhoki and Moll (2019), Buera and Fattal-Jaef (2018), Ottonello and Winberry (2023)

- ▶ Market power at the macro-level:

De Loecker et al. (2020), Basu (2019), Syverson (2019), Crouzet and Eberly (2019), Covarrubias et al., (2020), Ridder et al. (2022), Raval (2023)

- ▶ **Key takeaways:**

- ▶ Optimal competition policy depends on the degree of financial development.
  - ▶ Financial development policies have *pro-competitive* effects.

# This Paper

## 1. Empirical Analysis:

- ▶ use large administrative firm-level dataset covering the population of non-financial firms in Portugal
- ▶ document stylized facts about innovation

## 2. Quantitative Model:

- ▶ general equilibrium framework with heterogeneous producers engaged in monopolistic competition
- ▶ firms make dynamic decisions regarding investment and innovation

## 3. Policy Counterfactuals:

- ▶ competition policy reforms
- ▶ financial development policies

# Data

- ▶ The empirical analysis is based on the Central Balance Sheet Database (CBSD) maintained by the Bank of Portugal.
  - ▶ Harmonized annual data: balance sheet + income statement + demographic/corporate info
  - ▶ Mandatory annual declaration → covers the population of non-financial corporations in Portugal from 2006 to 2019
- ▶ Two complementary metrics to proxy for **innovation**:
  - ▶ **Employees engaged in R&D** (include those working on new product design, manufacturing, commercialization, or process improvement)
  - ▶ **Book value of intangible capital** (although costs related to R&D activities are typically recognized as an expense on the income statement, certain R&D expenses related to the development of new products, processes, or software can be capitalized as intangible assets)

- ▶ I estimate firm-level **markups** using the production approach (Hall, 1988; De Loecker and Warzynski, 2012; De Loecker et al., 2020), which is based on the cost minimization of a variable input of production (intermediate inputs):

$$\mu_{ist} = \frac{\theta_{st}^V}{\alpha_{ist}^V}$$

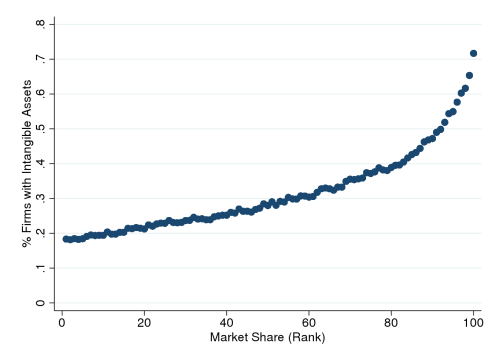
where  $\theta_{st}^V$  is the output elasticity of a variable input (estimated for each sector) and the revenue share of that input  $\alpha_{ist}^V = P_{it}^V V_{it} / P_{it} Q_{it}$ .

- ▶ Allows for inferring the full distribution of markups without imposing parametric assumptions on consumer demand, the underlying nature of competition, or returns to scale.
  - ▶ Literature discussing the validity of estimating markups using the production approach: Flynn et al. (2019), Kirov and Traina (2021), Ridder et al. (2022), Raval (2023), Bond et al. (2021), Basu (2019), Syverson (2019), Doraszelski and Jaumandreu (2021)

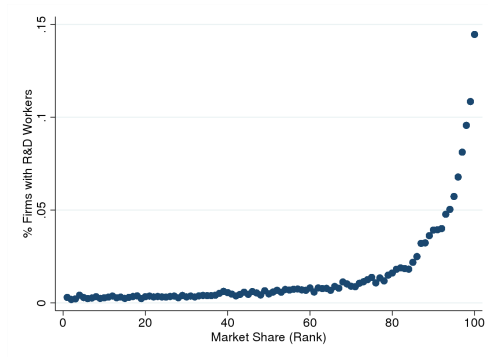
# Extensive Margin

- ▶ The prevalence of **intangible capital** and **R&D labor** increases with firm size.

Panel A: Share of Firms with **Intangible Capital**



Panel B: Share of Firms with **R&D Workers**



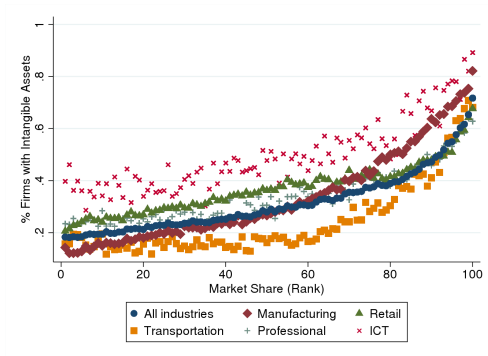
*Notes:* Binscatter displaying the extensive margins of R&D and Intangible Capital along the size distribution. Firms are ranked according to market share in their respective industries (defined as the first level of NACE codes - 18 industries). Each bin groups together firms with similar market shares and displays the fraction of firms with positive intangible assets in Panel A and the fraction of firms with workers allocated to R&D activities in Panel B.



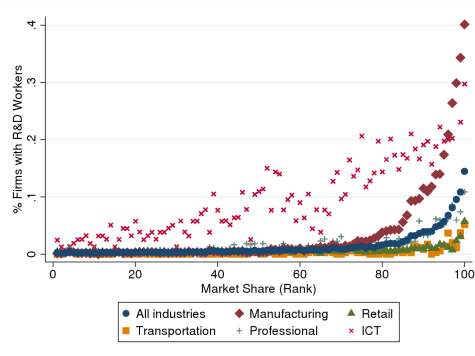
# Extensive Margin

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# Intensive Margin

- Higher **innovation** intensity is associated with higher **market shares**.

$$\text{Log(Market Share)}_{it} = \beta_0 + \beta_1 X_{it} + \Gamma' Z_{it} + \Omega' W_i + \delta_t + \varepsilon_{it}$$

	Log(Market Share)	
	(1)	(2)
Log(R&D Emp)	0.480*** (0.011)	
Log(Intan Cap)		0.160*** (0.001)
Industry FE	Y	Y
Year FE	Y	Y
Firm Controls	Y	Y
Observations	12,642	273,581
Adjusted $R^2$	0.448	0.527

Notes: Robust standard errors in parentheses. \*\*\*  $p < 0.01$ , \*\*  $p < 0.05$ , \*  $p < 0.10$ . The dependent variable is the firm's (log) market share, with markets defined as the first level of NACE codes (18 industries). Firm controls include size, age, export status.

# Intensive Margin

- Higher **innovation** intensity is associated with higher **markups**.

$$\text{Log(Markup)}_{it} = \beta_0 + \beta_1 X_{it} + \Gamma' Z_{it} + \Omega' W_i + \delta_t + \varepsilon_{it}$$

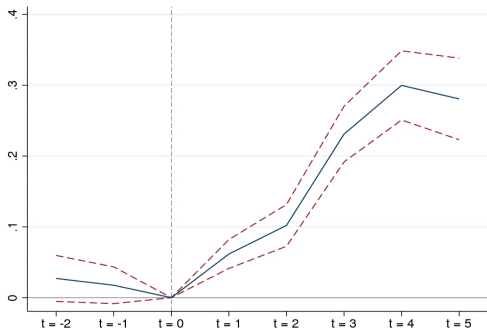
	Log(Markup)	
	(1)	(2)
Log(R&D Emp)	0.022*** (0.002)	
Log(Intan Cap)		0.001*** (0.0002)
Industry FE	Y	Y
Year FE	Y	Y
Firm Controls	Y	Y
Observations	12,642	273,581
Adjusted $R^2$	0.239	0.205

Notes: Robust standard errors in parentheses. \*\*\* p<0.01, \*\* p<0.05, \* p<0.10. The dependent variable is the (log) markup estimated following with a translog production function. Firm controls include size, age, export status.

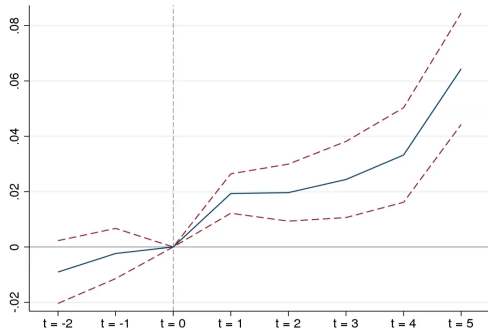
# Innovation Spells

- ▶ An **innovation spell** refers to a continuous period of time during which the firm has at least one R&D worker in every consecutive year after previously having none.

Panel A: Evolution of **Market Shares**



Panel B: Evolution of **Markups**



Notes: Estimated trajectories of market shares (Panel A) and markups (Panel B) before and after an innovation spell. The estimated regression is:  $y_{it} = \sum_{\tau=-2}^5 \mathbb{I}(t = \tau) + \Gamma' Z_{it} + \Omega' W_i + \delta_t + \varepsilon_{it}$ . Innovation spells begin at  $t = 1$ . Outcomes are expressed in relation to the reference year  $t = 0$  (omitted category), i.e., the year immediately preceding the start of the innovation spell. All estimated trajectories are conditional on industry- and year-fixed effects. Firm demographics include size, age, and export status. The dashed lines correspond to 95% confidence intervals.

▶ Robustness

# Model

- ▶ Standard model of heterogeneous entrepreneurs à la Buera et al. (2011) and Gopinath et al. (2017) augmented to include:
  - ▶ Variable markups
  - ▶ Innovation choice
- ▶ Innovation is modeled as a a **productivity-enhancing process**, capturing both *product* and *process* innovation.
- ▶ Firms engaged in R&D activities are more productive and able to capture higher market shares. As such, their products face lower demand elasticity and command higher markups.
- ▶ Since innovation is costly, a firm's ability to exercise market power determines how quickly it can overcome financial constraints and engage in innovation.

# The Economy

- ▶ There is a large number of infinitely lived firms, indexed by  $i = 1, \dots, N$ , that produce differentiated varieties.
- ▶ Firms are owned by risk-averse entrepreneurs who can save and borrow in a one-period bond at an exogenous real interest rate  $r_t$ .
- ▶ There is a fixed mass  $\bar{L}$  of hand-to-mouth workers who supply labor inelastically at an equilibrium wage rate  $w_t$ .
- ▶ Firms have a choice between two production technologies:
  - ▶ Traditional technology ( $\tau$ )
  - ▶ R&D-intensive technology ( $\kappa$ )
    - ▶ Labor allocation: Production vs R&D
    - ▶ Fixed costs

▶ Traditional Technology

▶ R&D-Intensive Technology

# The Economy

## ▶ Market Structure:

▶ Market Structure

- ▶ The firm accrues market power as it grows in size: the demand elasticity of each firm's variety decreases with its market share. The rate at which demand elasticity falls with market share is governed by the superelasticity of demand.

## ▶ Productivity:

▶ Productivity

- ▶ Idiosyncratic productivity shocks. No aggregate uncertainty.

## ▶ Financial Markets:

▶ Financial Markets

- ▶ Borrowing is limited by imperfect enforceability of contracts: firms can only borrow up to a fraction of their capital stock.

## Recursive Formulation

Letting  $a_{it} = k_{it} - b_{it}$  denote the firm's net worth, and using primes to denote next-period variables, we can rewrite the firm's problem in recursive form as follows:

$$V(a, z) = \max\{V^T(a, z), V^K(a, z)\}$$

$$V^T(a, z) = \max_{c, a'} \{u(c) + \beta \mathbb{E}V(a', z')\}$$

$$\text{s.t.: } c + a' = \pi + (1 + r)a$$

$$\pi = \max_{k, l} \{py - (r + \delta)k - wl\}$$

$$y = \exp(z) k^\alpha l^{1-\alpha}$$

$$p = \Upsilon' \left( \frac{y}{Y} \right)$$

$$k \leq \lambda a$$

$$V^K(a, z) = \max_{c, a'} \{u(c) + \beta \mathbb{E}V(a', z')\}$$

$$\text{s.t.: } c + a' = \pi + (1 + r)a$$

$$\pi = \max_{k, l, \nu \leq 1} \{py - (r + \delta)k - wl - c_f\}$$

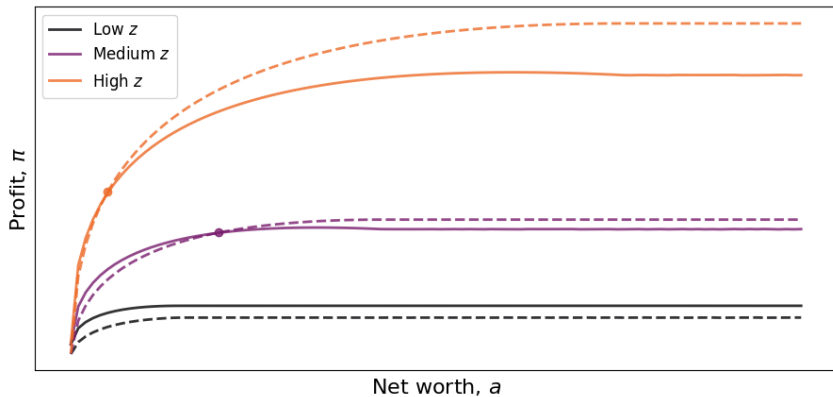
$$y = \exp(z + \xi \log \nu) k^\alpha (l - \nu)^{1-\alpha}$$

$$p = \Upsilon' \left( \frac{y}{Y} \right)$$

$$k \leq \lambda a$$

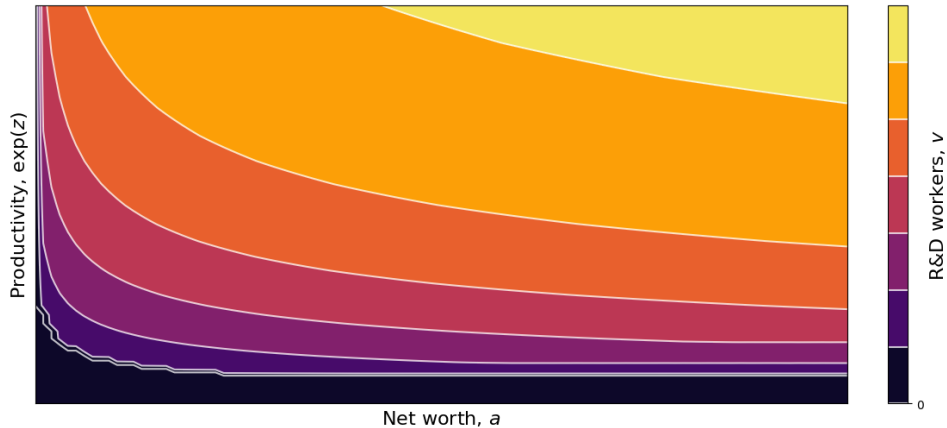


## Extensive Margin



*Notes:* Profit functions for traditional and R&D-intensive technology according to productivity and net worth. Solid lines represent profit under traditional technology. Dashed lines represent profit under R&D-intensive technology.

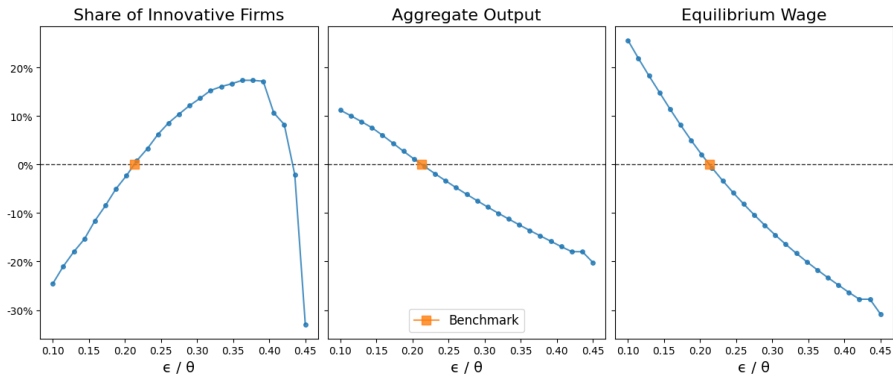
# Intensive Margin



*Notes:* Contour plot shows the intensive margin of innovation according to productivity and net worth. While productivity plays a crucial role in determining the number of workers assigned to R&D activities, these decisions are also significantly influenced by the level of net worth. In particular, high-productivity firms with low net worth will pursue suboptimal levels of R&D activity.

# Policy I: Competition Policy Reforms

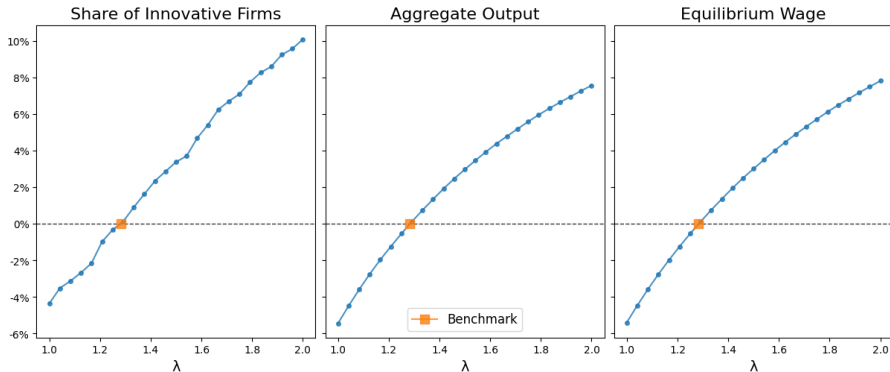
- ▶ In the model, the speed at which firms can accumulate market power is governed by the superelasticity of demand  $\epsilon/\theta$ . (intensifying competition  $\Rightarrow \downarrow \epsilon/\theta$ )



- ▶ Policies that intensify competition among firms can come at a cost of lower innovation if borrowing constraints are severe.
- ▶ The incentive to invest in costly innovation dissipates if firms are able to quickly accumulate market power.

## Policy II: Financial Development

- ▶ In the model, the tightness of the borrowing constraint and therefore the level of financial development is governed by the parameter  $\lambda$ . (improving financial development  $\Rightarrow \uparrow \lambda$ )



- ▶ Improving firms' access to external funding increases the share of innovative firms by allowing productive firms to expand and grow out of their financial constraints. This increases aggregate output and wages.

# Conclusion

- ▶ Documented stylized facts about innovation using a comprehensive firm-level dataset from Portugal.
  - ▶ R&D labor and intangible capital are associated with higher market shares and markups, both at the extensive and intensive margins.
  - ▶ Innovation spells are accompanied by large and persistent increases in both markups and market shares.
- ▶ Motivated by the empirical evidence, I develop a framework of heterogeneous producers that make dynamic decisions regarding investment and innovation.
  - ▶ Improving financial markets allows firms to expand and engage in innovation, whereas intensifying competition may come at the cost of lower innovation when firms face borrowing constraints.
- ▶ These findings underscore the importance of tailoring a country's competition policy to its level of financial development.
  - ▶ More generally, opens the door to thinking about issues of optimal competition policy at various stages of development and under different institutions.



# Intensive Margin

- Higher **innovation** intensity is associated with higher **market shares**.

$$\text{Log(Market Share)}_{it} = \beta_0 + \beta_1 X_{it} + \Gamma' Z_{it} + \Omega' W_i + \delta_t + \varepsilon_{it}$$

	Log(Market Share)					
	(1)	(2)	(3)	(4)	(5)	(6)
Log(R&D Emp)	0.539*** (0.012)	0.480*** (0.011)	0.107*** (0.008)			
Log(Intan Cap)				0.172*** (0.001)	0.160*** (0.001)	0.023*** (0.001)
Industry FE	Y	Y	Y	Y	Y	Y
Year FE	Y	Y	Y	Y	Y	Y
Firm Controls	-	Y	Y	-	Y	Y
Firm FE	-	-	Y	-	-	Y
Observations	12,646	12,642	11,280	273,582	273,581	259,264
Adjusted R <sup>2</sup>	0.305	0.448	0.975	0.445	0.527	0.970

Notes: Robust standard errors in parentheses. \*\*\* p<0.01, \*\* p<0.05, \* p<0.10. The dependent variable is the firm's (log) market share, with markets defined as the first level of NACE codes (18 industries). Firm controls include size, age, export status.

# Intensive Margin

- Higher **innovation** intensity is associated with higher **markups**.

$$\text{Log(Markup)}_{it} = \beta_0 + \beta_1 X_{it} + \Gamma' Z_{it} + \Omega' W_i + \delta_t + \varepsilon_{it}$$

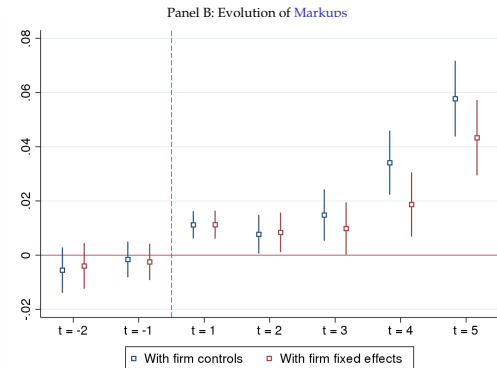
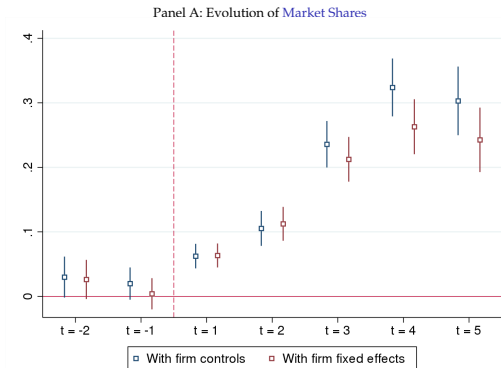
	Log(Markup)					
	(1)	(2)	(3)	(4)	(5)	(6)
Log(R&D Emp)	0.022*** (0.005)	0.022*** (0.002)	0.009*** (0.003)			
Log(Intan Cap)				0.001*** (0.0002)	0.001*** (0.0002)	0.002*** (0.0002)
Industry FE	Y	Y	Y	Y	Y	Y
Year FE	Y	Y	Y	Y	Y	Y
Firm Controls	-	Y	Y	-	Y	Y
Firm FE	-	-	Y	-	-	Y
Observations	12,646	12,642	11,280	273,582	273,581	259,264
Adjusted R <sup>2</sup>	0.237	0.239	0.802	0.202	0.205	0.809

Notes: Robust standard errors in parentheses. \*\*\* p<0.01, \*\* p<0.05, \* p<0.10. The dependent variable is the (log) markup estimated following with a translog production function. Firm controls include size, age, export status.



# Innovation Spells

- ▶ An **innovation spell** refers to a continuous period of time during which the firm has at least one R&D worker in every consecutive year after previously having none.



Notes: Estimated trajectories of market shares (Panel A) and markups (Panel B) before and after an innovation spell. The estimated regression is:  $y_{it} = \sum_{\tau=-2}^5 \mathbb{I}(t = \tau) + \Gamma' Z_{it} + \Omega' W_i + \delta_t + \varepsilon_{it}$ . Innovation spells begin at  $t = 1$ . Outcomes are expressed in relation to the reference year  $t = 0$  (omitted category), i.e., the year immediately preceding the start of the innovation spell. All estimated trajectories are conditional on industry- and year-fixed effects. Firm demographics include size, age, and export status. The vertical lines correspond to 95% confidence intervals.

## Traditional Technology

- ▶ The production function with traditional technology is a Cobb-Douglas, constant returns-to-scale function:

$$y_{it}^{\tau} = \exp(z_{it}) k_{it}^{\alpha} l_{it}^{1-\alpha}$$

where  $y_{it}$  denotes physical output,  $z_{it}$  is the firm's idiosyncratic productivity,  $k_{it}$  is the capital stock,  $l_{it}$  is labor.

- ▶ Given factor prices  $w_t$  and  $r_t$ , the profit of a firm operating the traditional technology is:

$$\pi_{it}^{\tau} = p_{it} y_{it}^{\tau} - (r_t + \delta) k_{it} - w_t l_{it}$$

where  $p_{it}$  is the price of its variety, and  $\delta$  is the rate of depreciation of capital.

## R&D-Intensive Technology

- ▶ The production function using R&D-intensive technology is given by:

$$y_{it}^{\kappa} = \exp(z_{it} + \phi(\nu_{it})) k_{it}^{\alpha} (l_{it} - \nu_{it})^{1-\alpha}$$

where  $\nu_{it}$  represents the portion of the firm's workforce allocated to R&D activities. Labor allocated to R&D is not available to produce.

- ▶ Taking the path of  $r_t$  and  $w_t$  as given, the profit of the R&D-intensive firm is:

$$\pi_{it}^{\kappa} = p_{it} y_{it}^{\kappa} - (r_t + \delta) k_{it} - w_t l_{it} - c_f$$

where  $c_f$  denotes fixed operating costs. All labor (including productive and R&D work) is assumed to be remunerated at the same wage rate.

- ▶ The function  $\phi(\nu_{it}) = \xi \log \nu_{it}$  disciplines the relative productivity of R&D work.

# Market Structure

- ▶ Each firm  $i$  is the sole supplier of a given variety. There is a total number of  $N_t$  varieties.
- ▶ A perfectly competitive final good firm produces the homogeneous output good  $Y_t$  by assembling all available varieties:

$$\int_0^{N_t} \Upsilon \left( \frac{y_{it}}{Y_t} \right) di = 1 \quad (1)$$

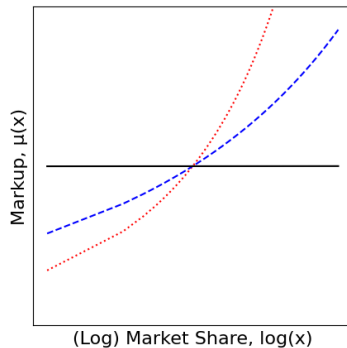
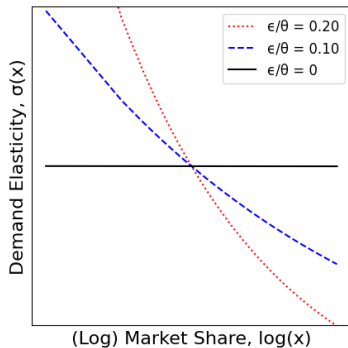
where  $\Upsilon$  is the Kimball aggregator, which is strictly increasing and concave, that is,  $\Upsilon' > 0$ ,  $\Upsilon'' < 0$ , with  $\Upsilon(1) = 1$ .

- ▶ Following the literature, I adopt the Klenow and Willis (2016) which yields the following inverse demand function for each variety  $i$ :

$$p(y_{it}) = \Upsilon' \left( \frac{y_{it}}{Y_t} \right) = \left( \frac{\theta - 1}{\theta} \right) \exp \left( \frac{1 - \left( \frac{y_{it}}{Y_t} \right)^{\frac{\epsilon}{\theta}}}{\epsilon} \right) \quad (2)$$

- ▶ Under this specification, demand elasticity and markups vary according to the firm's market share.

# Market Structure



- ▶ Demand elasticity  $= -\frac{\Upsilon'(x)}{\Upsilon''(x)x} = \theta x^{-\frac{\epsilon}{\theta}}$  (large firms face less elastic demand)
- ▶ Superelasticity of demand  $= -\frac{d \ln \sigma(x)}{d \ln x} = \frac{\epsilon}{\theta}$  (rate of change of elasticity is constant)
- ▶ CES case when  $\epsilon \rightarrow 0$

# Productivity

- ▶ Firms are subject to idiosyncratic productivity shocks but there is no aggregate uncertainty.
- ▶ Productivity  $z_{it}$  is stochastic and evolves according to an AR(1) Markov process:

$$z_{it+1} = \rho z_{it} + \varepsilon_{it} \quad \varepsilon_{it} \sim N(0, \sigma^2) \quad (3)$$

where  $\rho$  measures the degree of persistence in productivity, and  $\sigma^2$  is the variance of stochastic idiosyncratic risk.

# Financial Markets

- ▶ Firms can only borrow intra-temporally up to a portion of their capital stock. The borrowing constraint is given by:

$$k_{it+1} \leq \lambda a_{it+1} \tag{4}$$

where  $\lambda$  indexes the tightness of the borrowing constraint, and  $a_{it+1}$  denotes the firm's net worth, i.e., capital stock minus debt.

- ▶ If  $\lambda = 1$ , firms operate in a zero credit environment, whereas if  $\lambda = \infty$ , firms become financially unconstrained.

# Calibration

Target	Data	Model	Parameter	Value
<i>Exogenously Calibrated</i>				
Risk aversion			$\gamma$	1.50
Discount factor			$\beta$	0.87
Depreciation rate			$\delta$	0.06
Capital share			$\alpha$	0.33
Interest rate			$r$	0.05
<i>Endogenously Calibrated</i>				
Serial Correlation of Output	0.730	0.921	$\rho$	0.918
Top 10% Employment Share	0.509	0.528	$\sigma$	0.340
Avg Debt-to-Equity	0.281	0.263	$\lambda$	1.283
Average Markup	1.245	1.324	$\theta$	4.039
P90 Markup	1.765	1.773	$\epsilon/\theta$	0.213
Avg Share of R&D Workers	0.072	0.062	$\xi$	0.044
Relative Scale of R&D firms	8.808	9.887	$c_f$	0.001



## Quantitative Fit

Untargeted Moments	Data	Model
Share R&D Firms	0.115	0.105
Elasticity of Market Share wrt R&D	0.539	1.434
Elasticity of Markup wrt R&D	0.022	0.620