Misallocation and Manufacturing TFP In China and India (Hsieh and Klenow, 2009)

Companies uses inputs to make a product. Typically, economists summarize those inputs as capital (machines) and labor (workers). Two companies, with the same inputs, can produce different quantities. In the field, we capture those differences as *productivity*. One explanation is that each firm has a different level of technology. However, a recent strand of literature focuses on the allocation of resources between firms that explain said differences.

One Sentence Summary

Inefficient allocation of inputs (labor and capital) can induce a lower aggregate productivity equilibrium. If China and India reallocate resources in the same way as USA, their productivity will rise.

Main Findings

In a competitive market, efficient allocation of resources is automatic – thanks to the *invisible hand*. A worker is paid in wages proportionally to their productivity. Meanwhile a worker that is more productive in another company, will relocate and earn a higher wage.

There are some distortions that hinder efficient distribution of labor and capital. Some companies will have several workers that are more productive in another firms, but they will not change because their wages are artificially high. With this distortion, some high productive workers work for low productivity companies. This means that aggregate productivity is lower than it could be.

The authors found that if China and India adopt the efficiency levels of USA, they will experience an increase in productivity of 30-50% and 40-60%, respectively. They recommend less mid-sized production plants, and more small and large ones.

China inefficiency is captured by the large number of state-run companies, which are highly subsidized from 1998 to 2001. In 2005 most state-owned low productivity companies disappeared from the market, increasing China's productivity.

The Indian government restricts size of plants and limits commercial licensing. Size restrictions lead some firms to suboptimal sizes and less firms with scaled economies. Whereas licensing can make the process of plant creation more tedious and costly.

Concluding Remarks

The modern economy is characterized by the increasing importance of technology and productivity for economic growth. Governments should be extra careful when designing policies to fix market failures. As policies directed to workers and capital can have a profound impact on their countries productivity due to an inefficient redistribution of production inputs.

References

- Hsieh, C.T., Klenow, P.J., 2009. Misallocation and manufacturing TFP in China and India. Q. J. Econ. https://doi.org/10.1162/qjec.2009.124.4.1403.