

ECA RESEARCH NOTES

Office of the Chief Economist

EUROPE AND CENTRAL ASIA



Competition and Star Firms
February 2021



Hi Everyone,

We have been fortunate to enjoy a little bit of snow in Washington this month – a rare occasion here the last few years - but no more snow days for us... We have been busy working on our Spring Economic Update that will feature governance in our region and how the data revolution and digitalization can provide opportunities to improve it.

Governance issues also often manifest themselves as concentration and lack of access – limiting competition. So, this month's focus is on competition. Many economists think that in the absence of any government intervention, markets naturally become competitive, and that being bigger is associated with being better.

Technology and globalization have been creating opportunities for some firms to become stars and perform much better than the rest of the economy. There is much to be excited about when it comes to the rise of stars: they accelerate growth because they are the most productive and are at the forefront of new technologies, they drive out inefficient firms, and lower prices for customers. With increases in market concentration, frequently firm margins also increase, and anticompetitive behavior is difficult to identify in digital economy. Network effects often benefit early adopters of technology, giving significant power to incumbents. So, some modern tech firms may be realizing profits the old-fashioned way – by limiting competition.

It is not surprising then to see economists and policymakers increasingly turn their attention to these star firms. Important questions include: What are the drivers of market power? How do we effectively identify anticompetitive behavior in a digital economy? What should regulation look like? And will fiscal support to fight the Covid-19 pandemic lead to greater concentration of power and firm size globally, further muffling competition in the recovery phase, when it is most needed?

We addressed these questions and more at our ECA Talk this month. There is also a round-up of papers and blogs on these topics for further reading. And stay tuned for more.

Happy Reading!

Asli

FEATURE STORY



The Design of Competitive Markets

What is the difference between Competition and Contraposition? In a recent ECA Talk, Luigi Zingales, Professor of Entrepreneurship and Finance at the University of Chicago Booth School of Business, discussed what it takes to design competitive markets.

[Video and event details](#)

Clockwise from upper left corner: Luigi Zingales, Asli Demirguc-Kunt, Sandeep Mahajan, Vojislav Maksimovic

RELATED RESEARCH

[The Rise of Star Firms: Intangible Capital and Competition](#)

Meghana Ayyagari, Asli Demirguc-Kunt, Vojislav Maksimovic, World Bank Policy Research Working Paper 8832 – April 2019

There is a divergence in the returns of top-performing firms and the rest of the economy, especially in industries that rely on a skilled labor force, raising concerns about their market power. The authors show that the divergence is explained by the mismeasurement of intangible capital. Some exceptional firms may pose concerns due to their potential to foreclose competition in the future.

[Does Competition from Informal Firms Hurt Job Creation by Formal Firms? Evidence Using Firm-Level Survey Data](#)

Mohammad Amin, World Bank Policy Research Working Paper 9515 – January 2021

Using firm-level survey data for manufacturing small and medium-size enterprises in 109 mostly developing countries, this study estimates the impact of competition from informal firms on the growth rate of employment among formal sector small and medium-size enterprises. The results show that the growth rate of employment declines significantly as competition from informal firms rises.

[Trade Policy and Market Power: Firm-Level Evidence](#)

Alan Asprilla, Nicolas Berman, Olivier Cadot, Melise Jaud, World Bank Policy Research Working Paper 9050 – October 2019

This paper identifies the effect of trade policy on market power through new data and a new identification strategy. The observed pricing-to-market behavior suggests that, although tariffs reduce the market power of foreign firms through classic rent-shifting effects, non-tariff measures alter market structure and reinforce the market power of non-existing firms, domestic and foreign ones alike.

[Entry Barriers, Idiosyncratic Distortions, and the Firm-Size Distribution](#)

Roberto N. Fattal-Jaef, World Bank Policy Research Working Paper 9027 – September 2019

Entry barriers are well captured by regulation-based indicators in advanced economies but are largely underestimated in middle- and low-income countries. Regulation-based indicators cannot account for cross-country differences in average firm size and underestimate the aggregate productivity gains associated with their removal by up to 8 percent on average.

[Corporate Market Power in Romania: Assessing Recent Trends, Drivers, and Implications for Competition](#)

Mariana Iooty, Georgiana Pop, Jorge Pena, World Bank Policy Research Working Paper 9487 – December 2020

This paper explores firm-level heterogeneity to identify the underlying drivers of market power trends in Romania and the implications for competition and economic growth. The results show that the average markup in Romania increased by around 15 percent between 2008 and 2017. A key driving force behind this aggregate trend was the ability of a small fraction of firms — that do not seem to follow the typical superstar firms' profile — to increase their markups.

[Identification Properties for Estimating the Impact of Regulation on Markups and Productivity](#)

James Sampi, Charl Jooste, Ekaterina Vostroknutova, World Bank Policy Research Working Paper 9523 – January 2021

This paper addresses several shortcomings in the productivity and markup estimation literature. It proposes the use of a quasi-maximum likelihood approach and a generalized estimator for the production function, which produces an unbiased measure of productivity that directly accounts for the joint impact of regulation on markups and productivity.

BLOGS

[Lend me a hand—bank market power and firm creation in innovative industries](#)

Fabrizio Core, January 25, 2021

There are many factors that a government should take into account in designing policies for young innovative firms. Among them, bank market power seems to have a prominent role, as in the presence of bank market power, innovative entrepreneurs are less likely to be funded.

[Read the blog »](#)

[Flatten the coronavirus curve, but don't flatline competition](#)

Tanja Goodwing & Georgiana Pop, April 21, 2020

In the face of a major economic recession caused by the coronavirus disease, does competition still matter? Yes. While households have reduced incomes, and firms depend on competitively priced inputs for financial recovery, competitive prices for goods and services will matter even more. Furthermore, the economic crisis may affect smaller firms and market entrants more than the big powerful firms.

[Read the blog »](#)

Who's afraid of big bad firms?

Meghana Ayyagari, Asli Demirguc-Kunt, & Vojislav Maksimovic, November 8, 2018

Policymakers are concerned that America's leading firms such as the FAANG stocks — Facebook, Apple, Amazon, Netflix and Google — are having adverse results on the rest of us and making economic policy less predictable. While the superstar firms have made life easier for many consumers, it's hard for economists not to wonder whether the effects of their stratospheric success are entirely benign.

[Read the blog »](#)

Superstar firms, market power, and corporate inequality: The role of intangible capital

Meghana Ayyagari, Asli Demirguc-Kunt, & Vojislav Maksimovic, October 8, 2018

The emergence of superstar firms that achieve vastly better returns on invested capital has led to concern that some sectors are too concentrated. This difference in returns may be accounted for by better measurement of intangible capital. These firms may not be exercising market power in ways that harm consumers in the short run, but policymakers should ensure that markets remain contestable.

[Read the blog »](#)

CALENDAR OF EVENTS

- **March 3, 2021, 10AM:** Joint ECA Talk - Poverty & Equity Seminar "*COVID-19 and Global Income Inequality*" featuring Sir Angus Deaton, Senior Scholar and Professor Emeritus at Princeton University
- **March 30, 2021:** Launch of Spring 2021 ECA Economic Update "Data, Digitalization and Governance"
- **May (TBD), 2021:** 2020 [ECA Academy](#) Award Ceremony with presentations of winning research

Check [ECA Lectures](#) and [ECA Talks](#) to learn more about our past and future events.

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