

Misallocation and Establishment Dynamics*

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April 21, 2013

Abstract

The gap between marginal revenues and marginal costs of inputs (i.e., distortions or wedges) at establishments potentially lower aggregate total factor productivity (TFP) by preventing efficient allocation of resources among incumbents, deterring entry and exit, and affecting technology choices. We investigate the impacts of distortions on aggregate TFP, entry and exit, and establishment-level productivity growth using a rich dataset of Japanese establishments falling into manufacturing industries. Our main findings are the followings. First, if capital and labor were reallocated in Japan to equalize marginal products to the extent observed in the United States, aggregate TFP would increase by 7.7%. Second, the efficient size distribution of establishments that would be realized without any distortions would be more dispersed than the actual one. Third, distortions have a significant negative impact on entry and exit as well as establishment-level productivity growth. We finally investigate the factors of distortions, obtaining evidence that financial constraints result in distortions on capital.

Keywords: Misallocation, Aggregate Total Factor Productivity (TFP), Establishment-size Distribution, Establishment Dynamics.

JEL Classification: O16, E44, E22.

*Comments from Naohito Abe, Kosuke Aoki, Masahiko Egami, Takatoshi Ito, Keiichiro Kobayashi, Tsutomu Miyagawa, Masayuki Nakagawa, Tomoyuki Nakajima, Kazuo Ogawa, Sjamsu Rahardja, Makoto Saito, Masaya Sakuragawa, Takayuki Tsuruga, Kozo Ueda, Tsutomu Watanabe, Catherine Wolfram, and other seminar participants at Hitotsubashi University, Nippon University, RI-ETI, Gakushuin University, Kyoto University, the Center for Research in Finance (CARF) at Tokyo University, the 23rd Annual East Asian Seminar on Economics (EASE) of the NBER, the 2012 Spring Meeting of the Japan Economic Association, and the 2012 Meeting of the Summer Workshop on Economic Theory (SWET) are gratefully acknowledged. K. Hosono gratefully acknowledges financial support from Grant-in-Aid for Scientific Research (S) No. 22223004, Japan Society for the Promotion of Science.

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