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Accounting for Rising Corporate Profits

Intangibles or Regulatory Rents?

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Corporate valuations relative to assets, as well as corporate profits, have seen a sustained rise in the United States over the last three decades. Do these increases signal that U.S. firms are extracting excessive profits? While a dynamic, competitive economy rewards innovative firms with high profits, sustained *aggregate* profits suggest, instead, that firms are able to get away with higher prices because competition is limited. With limited competition, they earn supra-normal profits called "economic rents." Sometimes firms engage in political "rent-seeking"—lobbying for regulations that provide them sheltered markets—rather than competing on innovation. What do today's high corporate profits imply for economic dynamism and inequality?

A large literature associates regulatory rents with diminished dynamism because of wasteful rent-seeking that creates barriers to entry or diverts talent from productive endeavors. In addition, inequality might result in part from political rent-seeking, and rising corporate valuations might generate greater wealth inequality and the rise of a rentier society.

Yet not all rents arise from political rent-seeking nor do all rents imply social waste. For example, firms can earn rents on innovations. These rents constitute an important incentive to innovation. Generally, firms capture returns on intangible investments as rents, that is, as supra-normal profits. This includes returns on R&D, on "brand capital," and on organizational investments. Thus, understanding the reason for rising valuations and profits is crucial for evaluating the implications of these trends.

My research explores the roles of intangible investments versus regulatory rents in accounting for the recent rise of corporate valuations and profits.

To do so, I argue that the complexity of regulation is a proxy for a wide range of rent-seeking activities—those regulations that are most contested tend to become the most complex. Using a new index of regulatory restrictions, along with measures of election spending and lobbying as additional proxies for political rent-seeking, I reject the view that industries with the greatest rents attract the greatest regulation. Instead, causality flows from regulation to higher corporate valuations. Nor does regulation tend to reduce profits by burdening firms with compliance costs. While self-interested regulators and politicians may well impose costs on firms (the "tollbooth" view), firms benefit from regulations overall.

These benefits, moreover, appear to be large. Regulation corresponds to an increase in corporate valuations of about $2 trillion in the sample. Regulation and campaign spending are responsible for an increase in markups on the order of 1 percent. That corresponds to about a $200 billion increase in transfers from consumers to firms each

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year. Most of this effect occurs in five heavily regulated industries: chemicals, including pharmaceuticals; petroleum refining; transportation equipment; electric, gas, and sanitary utilities; and communications.

Several tests suggest that the link between industry regulation and corporate profits is causal, flowing from regulation to profits. This is consistent with regulatory capture. While regulation might be initiated with the goal of fixing market failures or by government bureaucrats and politicians seeking to extract rents, the net effect is to increase rents for publicly listed corporations.

Thus much of the growth in corporate valuations and profits since 1980 can be accounted for by growing investments in intangibles, especially investment in R&D. But it appears that an even larger share of the rise in valuations and profits can be accounted for by factors associated with growing regulation and political activity, especially after 2000.

Some observers have highlighted the possible role of increasing industry concentration in generating economic rents. Using two different measures of concentration, I find only a weak relationship with profits that is neither statistically nor economically significant. However, that finding might simply mean that such broad industry measures do not capture the main sources of rents, which might occur in local or regional markets or in differentiated product niches or might be based on scarce government-supplied inputs.

Several qualifications affect the interpretation of these findings. First, regulatory rents are not substantial in most industries; they are highly concentrated in a small number of industries. This has implications for the dispersion of firm profits that might be related to rising interfirm wage inequality.

Second, this study only looks at publicly listed firms. The effect of regulation might be different on private firms, especially small firms. Indeed, if rents are created via barriers to entry, one might expect large firms to benefit and small firms to be harmed.

This raises an additional limitation. While this study finds a large, causal effect from regulation and political activity, it does not identify the actual mechanism at work. Do rents rise because of barriers to entry or because of a diversion of resources to rent-seeking or something else?

This is important for understanding the implications of the rise in regulatory rents and their normative significance. Not all rent-seeking activity is socially wasteful; clinical trials for drugs and pollution compliance costs may benefit society. But even in these cases, rising economic rents may dampen economic dynamism, creating social costs not considered in typical cost/benefit calculations of new regulations. The rising significance of election spending and lobbying in the empirical analysis makes these concerns particularly worrisome. In the long run, if regulatory rent-seeking decreases economic dynamism and increases economic inequality, the harm might be much greater than current static losses of consumer welfare.

NOTE

This research brief is based on James Bessen, "Accounting for Rising Corporate Profits: Intangibles or Regulatory Rents," Boston University School of Law Law & Economics Working Paper no. 16-18, May 2016, https://www.bu.edu/law/working-papers/accounting-for-rising-corporate-profits-intangibles-or-regulatory-rents/.