

ON FINANCE AS A THEORY OF TFP, CROSS-INDUSTRY PRODUCTIVITY DIFFERENCES, AND ECONOMIC RENTS*

Andrés Erosa, Ana Hidalgo Cabrillana

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Abstract

We develop a theory of capital-market imperfections to study how the ability to enforce contracts affects resource allocation across entrepreneurs of different productivities, and across industries with different needs for external financing. The theory implies that countries with a poor ability to enforce contracts are characterized by the use of inefficient technologies, low aggregate TFP, large differences in labor productivity across industries, and large employment shares in industries with low productivity. These implications are supported by the empirical evidence. The theory also suggests that entrepreneurs have a vested interest in maintaining a status quo with low enforcement.

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