




Big business stability and economic growth: Is what's good for General Motors good for America? ☆

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Abstract

What is good for a country may not be good for its big businesses, at least recently. More turnover in top businesses correlates with faster per capita gross domestic product, productivity, and capital growth; supporting Schumpeter's [1942. *Capitalism, Socialism and Democracy*, third ed., Harper & Bros., New York, NY] theory of “creative destruction”—innovative firms blooming as stagnant ones wither. These correlations are greater in more developed economies, supporting Aghion and Howitt's [1992. *A model of growth through creative destruction*. *Econometrica* 60, 323–351] thesis that creative destruction matters more to economies nearer the technological frontier. More big business turnover also correlates with smaller government, common law, less bank-dependence, stronger shareholder rights, and greater openness.

Introduction

National economies have landmark corporations. Maersk shipping symbolizes Denmark's maritime history, as Nokia marks Finland's new economy. Many, often the principals of such great businesses, link an economy's fortunes to those of its landmark firms. Most famously, Charles Wilson, then chairman of the now financially shaky General Motors (GM), testified at his 1953 Senate Armed Services Committee confirmation hearing to become US defense secretary that keeping his existing job would entail no conflict of interest since “what is good for the country is good for General Motors, and vice versa.”

Plausible arguments imply the opposite. Schumpeter (1912) attributes economic growth to upstart innovative firms arising and ruining doddering behemoths, a process Schumpeter (1942) dubs *creative destruction*. A feedback ensues, for today's upstarts not only become tomorrow's behemoths, but also inspire a new generation of upstarts that eventually repeat the cycle. Aghion and Howitt, 1992, Aghion and Howitt, 1998, Aghion, Angeletos, Banerjee, and Manova (2005), and others model this process formally. Nelson and Winter (1982) explain creative destruction by visualizing firms as collections of “routines” that develop

slowly and resist change. Routines let firms prosper if they fit current economic conditions: institutional constraints, consumer preferences, production technologies, and the like. But as conditions change, an economy needs upstarts with new routines to displace past winners, which intrinsically have difficulties changing their ways. All these arguments imply that Wilson is wrong, and that a negative correlation should be observed between the continuous dominance of large businesses and economic growth.

But Wilson's thesis has champions. A positive link might reflect large corporations prospering because they are well managed, and the wealth they create spilling over the economy (Chandler, 1977). Schumpeter (1942) amends his vision of creative destruction, arguing that large, quasi-monopolistic businesses can best finance ongoing innovation, which sustains both their dominance and their economy's growth. Schumpeter (1942) adds that such stability provides job security, which Holmstrom (1989) argues permits high risk—high return undertakings, including investments in firm-specific human capital that would pose unacceptable career risks to managers and employees in smaller firms. Galbraith (1967) adds that larger firms can better absorb advertising investments that shape demand for their products. Romer (1986) formalizes Schumpeter (1942), positing that investment in innovation is worth more to a larger firm because its innovation can enhance productivity on a larger scale of operations. Chandler (1990) likewise posits rising economies of scope and scale in ever larger corporations as the motive force beneath economic growth in industrial economies. In the management literature, D'Cruz and Rugman (2000) and others suggest large business enterprises create and capture various economies of scale and scope. In each of these views, a positive feedback ensues, with the dominance of large businesses enhancing their economic fortunes, which further heightens their dominance. This feedback, in turn, fuels overall economy growth. All of these perspectives suggest a positive correlation between and economy's prosperity and that of its large corporations.

Signing the relationship between economic growth and big business stability lets us hone away one or the other class of theories. Establishing a predominant direction of causality, though of interest per se, is thus not critical for this exercise. Schumpeter (2002), in the initially omitted Chapter 7 of Schumpeter (1912), reflects on the slippery epistemology of causation in economic growth. Recognizing that “[t]he distinction between both forces and their repercussions is of great analytical value in this as in any particular case,” he nonetheless concludes that economists must learn to deal with a dynamic growth process, “not with a causal chain of explanation.” We sidestep all this because our objective here is distinguishing one class of dynamic processes from the other, as a first pass at least, by signing the correlation in question.

We regress real per capita gross domestic product (GDP) growth, capital accumulation, and total factor productivity (TFP) growth from 1990 to 2000 for 44 countries on the stability of their top ten firms from 1975 to 1996, with controls for initial per capita GDP, level of education, and capital stock.¹ We say a leading 1975 business is stable if it survives to 1996 (it needs not remain in the top ten) and we explore different definitions of survival. The 1975–1996 window includes the first and last years for which we had comparable lists of leading businesses when we began this project. We measure growth in a ten-year window around the endpoint of the stability window, which smoothes business cycle and transient crisis effects.

We find faster growth in countries where big business is less stable, and the finding survives numerous robustness tests. This supports Schumpeter (1912), Nelson and Winter (1982), Aghion and Howitt, 1992, Aghion and Howitt, 1998, Aghion, Angeletos, Banerjee, and Manova (2005), and other like theories; but suggests more limited traction for theories of Chandler, 1977, Chandler, 1990, Schumpeter (1942), Galbraith (1967), Romer (1986), and D'Cruz and Rugman (2000), at least in the late 20th century. The latter class could predominate in other periods or in certain industries. We relegate these issues to future research.

Establishing a predominant direction of causality is still “of great analytic value.” Granger causality tests are unviable because the processes we study work over what Schumpeter (1912) calls the “very long run,” time in generations, not years. A useful panel would require past data at generational intervals, not filling in higher frequency data. We relate big business turnover to end-of-period growth because the latter is an overarching policy objective. Curiously, growth measured around the beginning of our window is uncorrelated with our big business stability measures. This is far from conclusive but loosely suggests big business stability causing slow growth. We attempt more rigorous identification with instruments commonly used in the literature, but all fail standard weak instruments tests, implying that instrumental variables regressions using any or all of these variables provide no more information about causality than ordinary least squares (OLS) (Staiger and Stock, 1997). Despite failing to identify a predominant direction of causality, this exercise elucidates the economics underlying our finding.

First, enumerating alternative stories consistent with a negative correlation underscores the relative plausibility of the Schumpeter (1912) theory of economic development. This is because we link faster growth to a higher death rate of old leading firms, not just to their displacement from the top ten list by new bigger firms. We define death as having less than one tenth the 1975 workforce in 1996. A range of reverse causality stories might link growth to the rise of new leading firms that eclipse still prosperous old firms. However, the only reverse causality story plausibly linking growth to the destruction of old leading firms is creative destruction itself, for Schumpeter (1912) explicitly envisions corporate turnover causing growth and growth causing corporate turnover.

Second, although they fail as instruments, a cadre of institutional variables can be usefully recast as potential latent factors (things that enhance both corporate turnover and economic growth) associated with the most plausible alternative stories. We propose that the size and quality of government, the development of the financial system, and the degree of economic openness all encapsulate such alternative stories. We therefore identify the proxies for these most correlated with big business stability, and rerun our regressions of growth on stability including them as additional controls. Because these factors are also all potentially related to the intensity of creative destruction itself, this procedure works against us. That is, controlling for these factors arguably also drains our analysis of much variation driven by creative destruction. Nonetheless, our results persist: Big business stability retains a negative sign, consistent with the Schumpeter (1912) view of upstart firms undermining stagnant behemoths. Unfortunately, because no list of potential latent variables can be exhaustive; this, too, can provide only circumstantial evidence consistent with creative destruction.

A final set of clues lies in subsample regressions. Aghion and Howitt (1998) argue that growth in high-income countries, already on or near the production possibilities frontier, requires creative destruction to push that frontier outward; but that rapid growth in low-income countries can arise from improved factor allocation (outward movement from deep beneath the frontier) in applying off-the-shelf technologies. Consistent with this, we find a stronger relation between big business stability and slow growth in a subsample of high-income countries.

Intriguingly, high-income countries’ growth correlates most strongly with large private sector firm turnover, while low income countries’ growth correlates mainly with sometime state-controlled enterprise (SCE) turnover. Because we disregard nationalizations and privatizations in calculating turnover, the destruction of SCEs, not their privatizations, correlates with growth. Moreover, the institutional variables discussed above are less important for low-income countries, suggesting a more direct link. We speculate that sometime SCEs in low-income countries might retain political influence to soften their budget constraints, distorting resource allocation and slowing growth (Kornai, 1986). Also, Marshall (1956, p. 339) writes that “a

government could print a good edition of Shakespeare's works, but it could not get them written." Shleifer and Vishny, 1994a, Shleifer and Vishny, 1994b and Shleifer (1996) formalize this to explain the museum pieces prominent in 1989 transition economy factories. If distrust of innovation persists in sometime SCEs, this too might directly retard growth. Thus, though privatization raises firm-level performance (Megginson, Nash, and van Randenborgh, 1994; La Porta and Lopez-de-Silanes, 1997; and World Bank, 1995), a drag on economy-level growth could linger if sometime SCEs continue to dominate.

These tests do not conclusively confirm our thesis, but they coalesce into strong circumstantial evidence that the Schumpeter (1912) process of economic development underlies economic growth in the late twentieth century.

The paper is organized as follows. Section 2 reviews the construction of our key variables, and Section 3 presents our main results. Section 4 discusses causality, identification, and latent variables. Section 5 describes subsample regressions, and Section 6 concludes.

Section snippets

Data and variables

This section describes the raw data used to construct our big business stability indexes. It then explains the indexes themselves, the growth measures, and the other variables central to our empirical tests....

Main findings

Our central finding is that a more stable list of large businesses is associated with slower growth. We first show this with simple correlations and then turn to regressions analogous to the basic models surveyed in Mankiw (1995) but include *stability* as an additional independent variable. The section concludes with a robustness discussion....

Causality

Section 3 establishes a robust negative relation between big business stability and growth, but its causal interpretation remains hypothetical. Growth might destabilize old big businesses, or the instability of old big businesses might fuel growth. Because the Schumpeter (1912) description of creative destruction explicitly implies both, while many alternative theories of economic growth imply neither, our result is useful without a clear delineation of causality. Nonetheless, ascertaining the...

Subsample regressions

Aghion, Angeletos, Banerjee, and Manova (2005) argue that economic growth differs qualitatively in high- versus low-income countries. They posit that creative destruction is important in developed countries, where growth requires innovation to extend the production possibilities frontier outward. In contrast, they argue that growth in developing countries requires capital accumulation to apply known technologies, moving the economy from deep inside the production possibilities frontier toward...

Conclusions

Countries whose rosters of big businesses change less from 1975 through 1996 exhibit slower per capita GDP growth, TFP growth, and (in some specifications) capital accumulation in the 1990s. These findings reflect old giants waning and all but disappearing, not just being eclipsed as new ones wax large.

Big businesses melt away less often where governments are larger, civil codes hold sway, red tape is denser, banks are more dominant, and the global economy less immanent. The link from big...

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