

## PUBLICATION FACTS

### JOURNAL

JOURNAL OF ECONOMIC  
DYNAMICS & CONTROL

### PUBLICATION DATE

2014

### VOLUME/ISSUE

46

### PAGES

114-129

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# IMPACT OF POLICY DISTORTIONS ON FIRM-LEVEL INNOVATION, PRODUCTIVITY DYNAMICS AND TFP

## ABSTRACT

A large literature emphasizes that distortions misallocate resources across firms and are a key source of productivity losses. This paper examines the dynamic effects of distortions when they affect not only the allocation of resources but also firm-level incentives to improve productivity. I consider a setting where firms spend on innovation and thereby influence the evolution of productivity. When distortions are tied to productivity, firm-level innovation falls and the distribution over productivity becomes right-skewed. Quantitatively, TFP and average output falls and is amplified through the innovation channel. When distortions are uniform across firms, instead of correlated with productivity, the effects on TFP and average output are dampened. (C) 2014 Elsevier B.V. All rights reserved.

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Journal Citation  
Indicator

**0.66**