



Firm entry deregulation, competition and returns to education and skill



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ABSTRACT

This paper studies the effect of firm entry deregulation on the returns to skill and education. We exploit a comprehensive episode of entry deregulation, unique in the industrialized world, as a quasi-natural experiment. Using matched employer–employee data for the universe of workers and firms in Portugal, we show that increased product market competition, which resulted from deregulation, increased the returns to a university degree and the returns to skill. We verify that our results are not driven by changes in employment composition, and are unlikely to be driven by skill-biased technical change, or by workers who change skill levels after the deregulation.

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1. Introduction

Whilst all countries regulate firm entry, the extent and nature of the regulations vary widely across the world.¹ Overly-restrictive regulations are likely to be inefficient and have knock-on effects on competition, innovation, employment, wages and economic growth. As a consequence, deregulation, and in particular the removal of restrictions on firm entry, has been a significant policy recommendation during the last few decades. These ideas also receive support in academic research. For example, Aghion et al. (2008) argue that deregulation associated with dismantling the License Raj in India led to firm entry and output growth. Aghion et al. (2009) show that policy reforms affecting firm entry conditions in the UK during the Thatcher era fostered incumbent innovation and productivity growth. Bertrand and Kramarz (2002) show that increased entry regulations in the retail trade industry in France had a negative effect on job creation and employment growth.²

This paper investigates the effects of deregulation on entry, competition, and the returns to education and skill. Using linked employer–employee data for the universe of private sector firms and workers in Portugal, we analyse the “On the Spot Firm”

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¹ Djankov et al. (2002) report that while in Italy an entrepreneur needs to follow 16 different procedures, pay US\$3946 in fees, and wait at least 62 business days to acquire the permits to start a business, an entrepreneur in Canada can finish the process in two days by paying US\$280 in fees and completing only two procedures.

² The positive effects in Aghion et al. (2008) are found in pro-employer states. In Aghion et al. (2009), sectors close to the technology frontier benefit because successful innovation allows incumbents to survive the threat. The negative effect in Bertrand and Kramarz (2002) is unambiguous.

program, an initiative created to reduce the time, cost, and complexity of registering a new business. Prior to 2005, an entrepreneur would need to visit several public offices to start a business. In all, it took 11 procedures, 20 forms, and 78 days, making it slower than in any other EU country (World Bank, 2006). The “On the Spot Firm” program created one-stop shops where entrepreneurs could register a company in a single visit. As a result of this reform, the process of starting a business can now be completed in less than an hour. Between 2005 and 2010, business registration fees dropped from 13.5% to 3% of GDP per capita, and Portugal rose from 113 to 26 in the “Doing Business” ranking of economies.

We exploit the cross-time and cross-municipality variation in the implementation of the “On the Spot Firm” program to identify and measure changes in the returns to education and skill from firm entry deregulation.³ Using the roll-out of the “On the Spot Firm” program as an exogenous source of increased product market competition, we provide quasi-natural experimental evidence on the impact of entry deregulation on wages. The unusually rich and detailed information from the employer–employee dataset *Quadros de Pessoal* also allows us to obtain estimates that account for individual- or match (firm-worker)-specific unobserved heterogeneity, as well as changes in industry composition and regional effects.

In line with theoretical results linking product market competition and relative wages (see Section 2), our estimates suggest that after the reform, the relative wage of university graduates increased by around 5%, while that of high-skilled workers increased by around 3%. In our empirical specifications, we control for individual fixed effects, thus eliminating potential biases arising from unobserved individual characteristics, and we control for industry, municipality, and year effects, to parse out any industry or region characteristics or business shocks that might affect our outcomes. We further saturate the models and include trends by municipality–skill (education) to account for any differential pre-existing trends in wages. In all cases, we find that the wage premium to education and skill remains similar in magnitude and statistical significance. Finally, we control for firm-worker (match) fixed effects. In those specifications, the effect of the reform on returns to education and skill is identified from individuals who stay in the same firm after the deregulation. Therefore, the wage effect we identify reflects not merely higher wages in new jobs, but is commensurate with education and skills becoming more valuable after the reform.

We also find that the “On the Spot Firm” program had a positive and statistically significant effect on firm creation. This is consistent with results reported in other studies interested in identifying the effect of deregulation on firm entry (for example, Bruhn (2011) uses a similar firm entry deregulation in Mexico). Our estimates show that the deregulation had a negative and statistically significant effect on industry concentration ratios, and on the Herfindahl–Hirschman index (HHI), suggesting that it increased competition within industries. Because common measures of competition face a number of limitations, which include potential endogeneity, correlation with omitted variables, and non-monotonicity, we believe that the main contribution of our paper is to use the “On the Spot Firm” as an exogenous shock that increased competition to estimate its effects on the returns to skill and education.

Our results of increased wage premia for skills (and education), following an episode of increased product market competition, complement those in Guadalupe (2007). She studies the effect of increased competition on the returns to skill resulting from the UK’s entry into the European Single Market Program and the 1996 appreciation of the British pound. She forcefully demonstrates that the returns to skill within an industry increase with foreign competition, whereas our analysis focusses exclusively on increased domestic competition. As such, we are able to provide independent evidence of the importance of greater product market competition on wages.

Our paper also contributes to a literature studying the effects of industry-specific deregulation episodes on wages, such as Rose (1987) and Card (1986).⁴ However, we investigate an economy-wide episode of entry deregulation, and study the effects on the returns to education and skills, a different aspect of the wage structure. Finally, a broader literature has shown that entry and competition spur productivity growth and innovation (e.g. Aghion et al., 2009; Djankov et al., 2006; Griffith and Harrison, 2004; Griffith, 2001, and Blundell et al., 1999). With most European countries experiencing poor economic performance, high unemployment, and weak fiscal positions, policies with the potential to raise growth, such as the reform studied here, are very appealing. Our results suggest that they may have implications for the distribution of income, which governments should at least be aware of.

The paper is organized as follows. The next section reviews the theoretical background and the related literature. In Section 3 we describe the “On the Spot Firm” program. Section 4 describes the data used and presents descriptive statistics and correlations between measures of competition and the returns to education and skill. Section 5 studies the effect of the reform on firm creation and on measured competition. Section 6 presents the quasi-natural experiment and discusses the results of the deregulation on the returns to education and skill. The last section concludes.

2. Theoretical background and related literature

To the extent that the business registration reform analyzed in this paper reduced entry barriers, it increased competition in the product market. In this section, we discuss the theoretical link between product market competition and relative

³ The program expanded over time to municipalities across the country and by the end of 2009 there were 164 one-stop shops dispersed throughout Portugal (see Fig. 1 in Section 3).

⁴ See Section 2 for a review of this literature.

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