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Product market competition, investment and employment-abundant versus job-poor growth: A real options perspective

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Abstract

The role of product market reforms in achieving the objective of higher employment and growth has recently received much attention amongst academics. The aim of this paper is to analyse some of the channels through which cross-market effects come about and to assess their policy relevance. The analytic strategy of this paper relies upon the stochastic real options modelling approach. In a nutshell, our simulations using numerical methods indicate that comprehensive product market reforms would increase factor demand and growth significantly in the medium and long run.
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1. Introduction

This paper contributes to the growing literature which aims to link barriers to competition on product markets and factor demand. The recent decline in economic growth in some European countries has intensified the debate surrounding the question of the extent to which the inertia of highly regulated labour and product markets has a negative impact on the creation of jobs and unemployment. Since the timing of UK and US product market deregulation, which began in the

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late 1970s, fits neatly into the picture of diverging labour market performance dating back to the 1980s, the regulatory product market environment is a smoking gun of sorts for divergent labour market performances across countries [see, e.g., Blanchard and Tirole (2004) and Nickell et al. (2005)].

In recent years the OECD has produced an internationally-comparable set of indicators that measure the degree to which policies promote or inhibit employment and competition in various areas of the product market.[1] A broad range of policies and institutional arrangements have influenced these differences. Using a multidimensional clustering approach, Boeri et al. (2000) have grouped the OECD countries into various clusters of institutional rigidities according to the degree of labour and product market regulation. They have identified four groups: (a) countries which combine tight regulation in both labour and product markets (France, Italy, Greece and Spain); (b) continental European countries with relatively restrictive product market regulation but with different employment protection legislation (Germany, Austria, the Netherlands, Finland and Portugal being more restrictive than Belgium and Denmark); (c) common law countries characterised by a relatively liberal approach in both labour and product markets (US, UK, Canada, Ireland, Australia and New Zealand), and (d) Sweden, which together with Japan, combines relatively restrictive labour market regulation with relatively few product market restrictions.[2]

All this is by way of prologue. A proper discussion of the effects that changing product market competition brings to the rest of the economy demands that policy oriented debate is placed within the context of economic theory. Once one moves away from the idea of a simple world where firms have perfect foresight, additional linkages and further questions suggest themselves. In particular, in an uncertain environment barriers to competition may affect not only the level of investment/hiring but also the timing of investment/hiring. Hence we contribute to the literature by taking the route of a real options modelling framework to shed more light on the regulation — factor demand nexus.[3]

Against this background, the remainder of the paper is structured as follows: Section 2 sets out the theoretical model. Section 3 focuses on our main research question – posed in the title of the paper – namely, how much of the labour-abundant versus job-poor growth experiences can barriers to competition explain? Some concluding remarks are offered in Section 4. Two appendices at the end of the paper collect some proofs and technical derivations which are rather involved. Readers who are not interested in the nuts and bolts of the derivations, can skip the appendices without losing the main argument of the paper.

[1] See http://www.oecd.org/document/1/0,2340,en_2649_201185_2367297_1_1_1_1,00.html. The indicator on product market regulation focuses on a subset of government-imposed restrictions. These include state control, barriers to entrepreneurship, barriers to trade and investment, and economic and administrative regulation. The indicator on employment protection summarises regulation for regular and temporary contracts. The 'Doing Business Database' of the World Bank also provides alternative measures of business regulations and their enforcement in international comparison. This dataset covers 145 countries and is benchmarked to January 2004 (see, http://rru.worldbank.org/DoingBusiness/).

[2] A number of insightful empirical studies have analysed the linkages between product market regulations and employment using these cardinal indicators, including Alesina et al. (2005), Angrist and Kugler (2003), Berger and Danninger (2005) and Hayri and Dutz (1999), IMF (2005) and Koedijk and Kremers (1996). These studies, however, suffer from two problems. First, most studies use country data, which "aggregates out" the true dynamics of factor demand. Second, either employment or investment is investigated instead of modelling them jointly.

[3] The analogy arises because factor adjustment costs are at least partially sunk. The consequences of uncertainty for the optimal conduct of factor demand have been a very active field of research in recent years. Amram and Kulatilaka (1999), Copeland and Antikarov (2001) and Dixit and Pindyck (1994) summarise the principle features of this class of model.

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