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REGULATION OF ENTRY AND THE DISTORTION OF INDUSTRIAL ORGANIZATION

Raymond Fisman
Columbia University and NBER

Virginia Sarria Allende*
IAE - Universidad Austral

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We study the distortions of industrial organization caused by entry regulation. We take advantage of heterogeneity across industries in their natural barriers and growth opportunities to examine whether industries are differentially affected in countries according to entry regulation. First, we consider the effect of entry regulation on the (static) industry structure. We find that regulation has a greater impact in industries with lower natural barriers to entry, both on the number of firms and on the average size of firms. We find that the effect of entry regulation on industry share is not related to differences in natural barriers. Regarding industry dynamics, we find that in countries with high entry regulation, industries respond to growth opportunities through the expansion of existing firms, while in countries with low entry regulation, growth opportunities lead to the creation of new firms; finally, the total sectoral response is invariant to the level of regulation.

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I. Introduction

Economists have presented two contrasting views of government regulation of economic activity. Under the Regulatory Capture view (Stigler 1971), regulation

* Sarria Allende (corresponding author): Mariano Acosta S/N° - Derqui (1629) Pilar – Buenos Aires, Argentina. E-mail: vsarria@iae.edu.ar. Phone: (54-2322) 48-1047. Fax: (54-2322) 48-1050. Fisman: 823 Uris Hall, Columbia University, New York, NY 10027. Email: rf250@columbia.edu. Phone: (212) 854-9157. Fax: (212) 854-9895. We are grateful to Kyle Bagwell, Charles Himmelberg and Laurie Hodrick for helpful comments and suggestions. We also thank seminar participants at Columbia University and an anonymous referee.

is acquired by industries, and is designed and operated for their benefit, through the increased market power that regulation allows. By contrast, the Public Interest perspective, as initially suggested by Pigou (1938), holds that industry will be fraught with inefficiencies stemming from market failures of all kinds, if left to its own devices. Regulation is therefore *required* to achieve socially efficient outcomes. Both perspectives suggest that entry regulation in particular will have an impact on industrial structure by directly influencing the costs of starting a new enterprise in a given industry, but differ in their views on the relative trade-off between the correction of externalities and the creation of market power. In order to appropriately assess the extent of this trade-off requires some empirical sense of the actual distortions that may be caused by regulatory burdens. Even though this paper does not deal with the actual *causes* of regulation, it sheds some light on the matter, by means of analyzing some interesting *consequences* of entry regulation.

There exists a nascent empirical literature examining the impact of entry regulation on economic outcomes. Two recent papers take contrasting approaches on this issue. Djankov et al. (2002) document significant differences across countries in the ease with which firms may open new businesses. They go on to examine a number of country-level outcomes and find that, consistent with the Public Choice view, entry regulation is associated with higher corruption and larger unofficial economies, but not higher quality of public or private goods. Bertrand and Kramarz (2002) look more closely at the effects of entry regulation on employment of the retail sector in France, taking advantage of regional and temporal variation in the stringency with which entry regulation was applied. They find that entry regulation decreases retail employment, partly due to the increase in concentration and the ensuing price upturns.

In our paper, we take an approach that empirically straddles the two papers described above. We take advantage of heterogeneity across industries in their natural barriers and growth opportunities to examine whether some industries are *differentially* affected in countries with high levels of entry regulation. This allow us to examine how entry regulation *differentially influences* industrial structure, as a function of industry characteristics, and the opportunities available to firms in that industry. This approach contrasts with Djankov et al., who examine the impact of regulation only at the country level – our approach allows for the inclusion of both country and industry fixed-effects, which mitigates some concerns of unobserved heterogeneity and reverse causality. Furthermore, Djankov et al. examine only ultimate (social) outcomes of entry regulation, rather than the direct impact upon industry structure that would be the primary consequence of regulations according