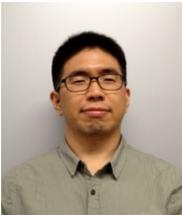


## Is Lowering Entry Barriers Always Good?



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The reallocation of production factors from low-productivity production units to high-productivity production units is at the heart of well-functioning market economies. Recent empirical studies find that the reallocation is quantitatively important. For instance, hypothetically reallocating production factors, Hsieh and Klenow (2009) calculate aggregate total factor productivity (TFP) gain of 30-50% in China and 40-50% in India. In the context of aggregate TFP growth in a developed economy, Petrin et al (2011) use the U.S. manufacturing plant-level data and document that the contribution of reallocation is 1.7-2.1% out of 2.2% aggregate productivity growth.

Entry costs are often blamed as a primary barrier to factor reallocation. In the face of entry costs, the valuable ideas of potential entrants would not be transformed into products. The view that such foregone product innovations could have improved the welfare of the overall economy has gained popularity among policy makers and politicians. In a similar vein, it is often argued that the process of starting and operating a new business is currently over-regulated and that costs should be cut in terms of resources and time of potential entrants. Using the World Bank's "Doing Business" dataset, Moscoso Boedo and Mukoyama (2012) find empirical support for the deregulation argument against entry costs; the cost and time of starting a business and dealing with business licenses tend to be negatively associated with GNI per capita relative to the U.S.

Nevertheless, it is hard to reach conclusions about deregulation against entry costs. Imagine that entry requires a fixed amount of labor and labor becomes more expensive with the level of development. In a positive sense, as a result, it is inevitable that entry costs rise with development. The recent study by Bollard et al (2014) estimates total entry costs, e.g. the sum of technological and regulatory barriers, and find that total entry costs tend to rise with value added per worker. Luttmer (2007) also shows that given that the U.S. firm size distribution is stationary over time, entry costs have to be proportional to the level of development.

In a normative sense, policies reducing entry costs and supporting product innovations do not always guarantee aggregate TFP gain but can only yield adverse TFP effects. The value of ideas by potential entrants has not been tested in a competitive market and it is costly to examine their value in advance. When the close examination of value is not technically feasible, policies reducing entry costs and supporting product innovations may introduce two opposing effects to an economy. In particular, the policies may generate new value-added but may also allocate production factors to low-productivity potential entrants. In well-functioning, competitive market economies, such adverse effects from cutback in entry costs may only have short-term and minor effects on economies because low-productivity entrants would not be able to survive competition in the long run. On the other hand, if economies feature distortions that inhibit factor reallocation across incumbent producers, low-productivity entrants might be able to stay and utilize production factors that could otherwise have been used by high-productivity production units. As a result, in economies with allocation distortions, which might be key characteristics of many developing countries, policies reducing entry costs and supporting product innovations would have long-term and substantial, adverse misallocation effects on the aggregate economy.

The goal of deregulation has to be to establish well-functioning, competitive market economies. To this end, priority has to be given to the mitigation of distortions involved with allocation across incumbent producers rather than elimination of entry barriers, especially in developing economies. For instance, deregulating factor adjustment and facilitating factor reallocation across incumbent producers would contribute to aggregate TFP gain. This way, a market selection mechanism is at work so that surviving producers are more productive than the ones that cannot survive. Reallocation between incumbent producers and entrants would naturally ensue once reallocation across incumbent producers is sustained in the proper direction. The argument, “deregulation for incumbent producers over entrants”, is not only confined to the entry of domestic producers but deserves serious consideration when we think about the entry of foreign producers into domestic factor markets. [KIEP](#)

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