Entry, Industry Dynamics and Competition Policy

José Mata
Nova University of Lisbon

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Competition Policy

- Competitive markets believed to lead to:
  1. Efficient allocation of resources
  2. Productive efficiency
- Role of Competition Policy
  a. Prevent conduct that raises prices
  b. Avoid conditions that perpetuate inefficiency

Competition Policy

- Has mostly focused on:
  - Conduct that raises prices
  - Industries with market power
- Should also apply to:
  - Pursuit of productive efficiency
  - All industries (irrespective of market power considerations)

The case for Competition Policy when there is market power

- Efficiency requires pricing at marginal cost
- Monopoly raises prices …
- … and hurts consumers
- Excess profits: symptom of market power
- Goal of competition policy: lower prices

In competitive industries …

…there is less reasons for concern

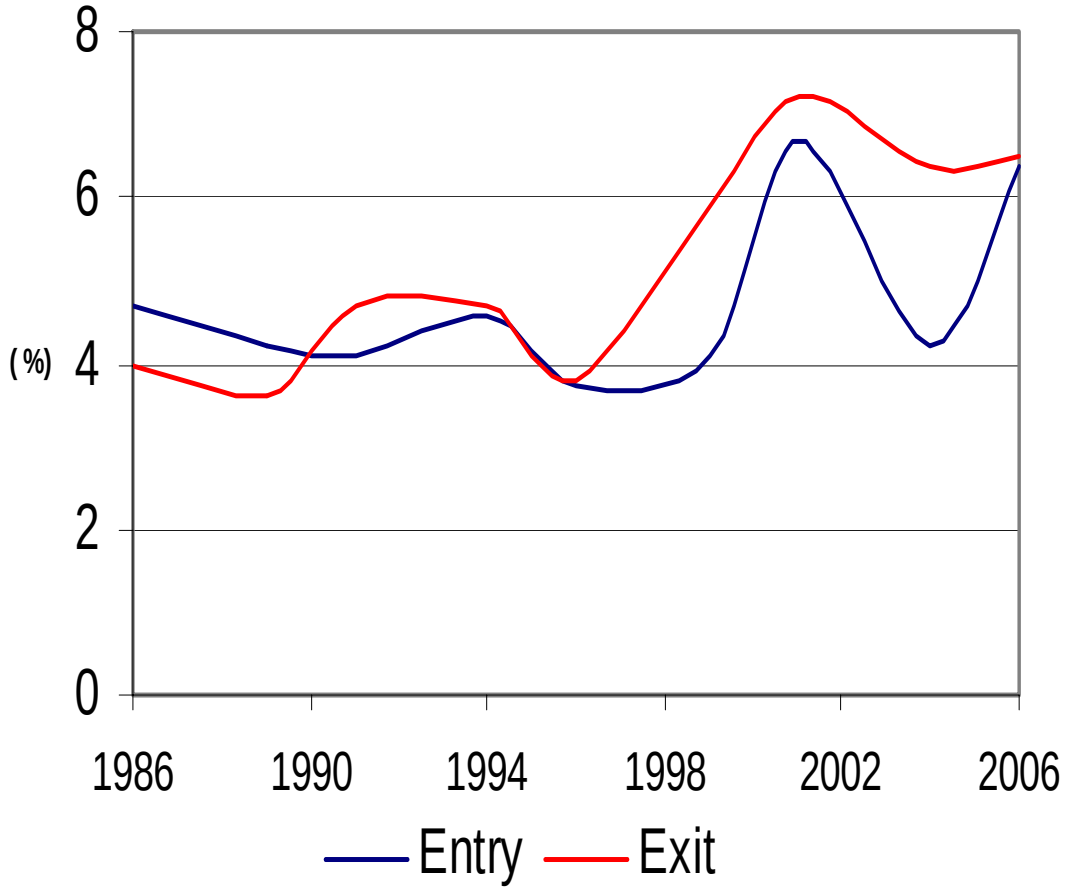
- Firms take price as given
  - Produce up to the point where marginal costs equal price
- Profits (and losses):
  - are transitory
  - are a signal that more firms are needed
  - lead to entry (losses lead to exit)
- In the long run
  - Profits are zero
  - No entry, no exit

In the textbook competitive market model

- Entry is an equilibrating mechanism
- All firms can access the same resources
  - No inefficient firms can survive
  - All firms are of the same size
- Entry and exit lead firms from one industry to another

Annual entry and exit rates in Japan

(establishments)



- Figures possibly lower than in other countries
- Very high compared to net entry

Source 2008 White Paper on Small and Medium Enterprises in Japan

Entry and exit (Japan 2004-06)

	Entry	Exit
Manufacturing	3.4	5.4
Wholesaling	5.6	6.4
Retailing	5.7	6.8
Services	6.4	5.9

Source 2008 White Paper on Small and Medium Enterprises in Japan

- Are not mostly due to re-estructing of the economy
- Occur in all (most) industries
- Positively correlated across industries

A different view of competitive industries (heterogeneous firms)

- Firms differ:
  - Entrepreneurs have different abilities
  - Entrepreneurs have different opportunity costs
- Firms will have different sizes
- Firms have different efficiency levels
  - Top firms are 3 to 4 times more productive than low productivity firms (9th vs 2n decile, TFP)
    - (Bartelsman and Doms 2000)

Entry occurs:

- not because all firms in industry are making profits,
- but because entrepreneurs believe that they can make a profit for themselves
  - even if others make losses
  - Entry occurs even in contracting industries

Uncertainty about entrants' abilities

- Entrants expect to be able to make money
  - but do not know for sure
- Entry in the market allows them to test their capabilities
  - Those that succeed survive and grow
  - will be able to accept lower prices and increase industry output
- Exitors of today:
  - Incumbents unable to cope with lowered prices
  - (Mostly) yesterday's entrants that did not succeed

Entry and exit - only the tip of the iceberg

- Productivity gains come from:
  - More efficient entrants
  - Exit of inefficient firms
  - Growth of more efficient and contraction of less efficient established firms
- The later is the most important:
  - Firms are entrants and exitors for brief moments
  - Entrants account only for a small share of industry output

Preparing to start a business in Japan

- Over 2% of the working population would like to start a business
- Over 1% is preparing to start a business
  - Source: Harada (2005), based on LFS

Some calculations

- Working population - 60 million
  - 1% of 60 million = 600 000
- Existing enterprises - 4 million
- If all firms that are being prepared were created
  - Entry rate would be 15% (= 600,000 / 4,000,000)
  - Observed entry rate is 4-6%

Costs of inhibiting reallocation

- Bureaucracy
- Costs of creating a firm
- Corruption
- Severance costs

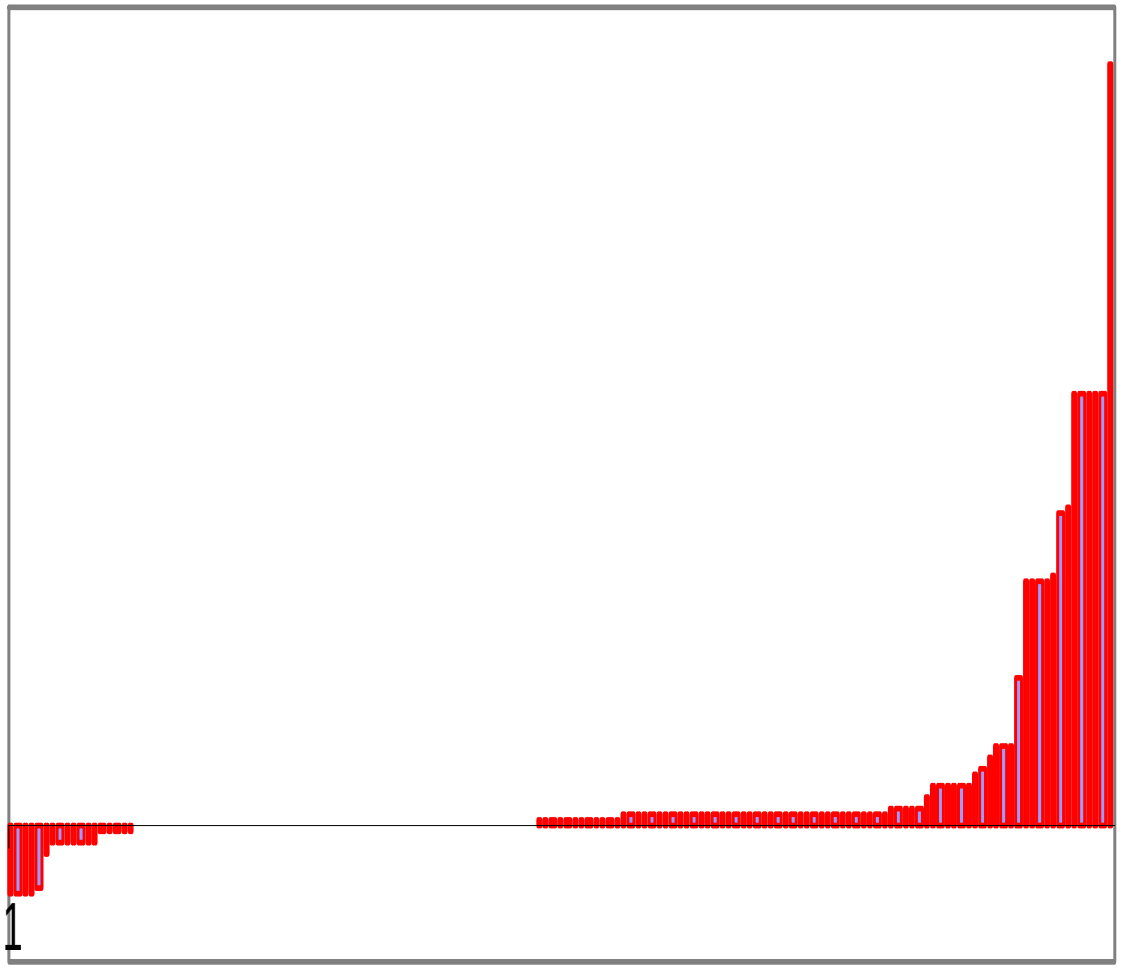
Example: costs of taxing job destruction

- Firms will be more cautious in creating jobs
  - More inefficient firms survive
  - Fewer efficient firms enter
  - Reallocation will be lower
- Calibration: tax equal to 1 year's wages
  - Reduces employment by 2.5 percent
  - Decreases productivity by 2 percent
  - Reduces consumption by 2 percent
    - Hopenhayn and Rogerson (2003)

The costs of inhibiting reallocation

- Costs will be higher if different firms confront different distortions
  - Cabral 2005
- Commonly discriminated firms
  - Foreign vs. domestic firms
  - Large vs. small firms

Entrepreneurial rewards are highly skewed



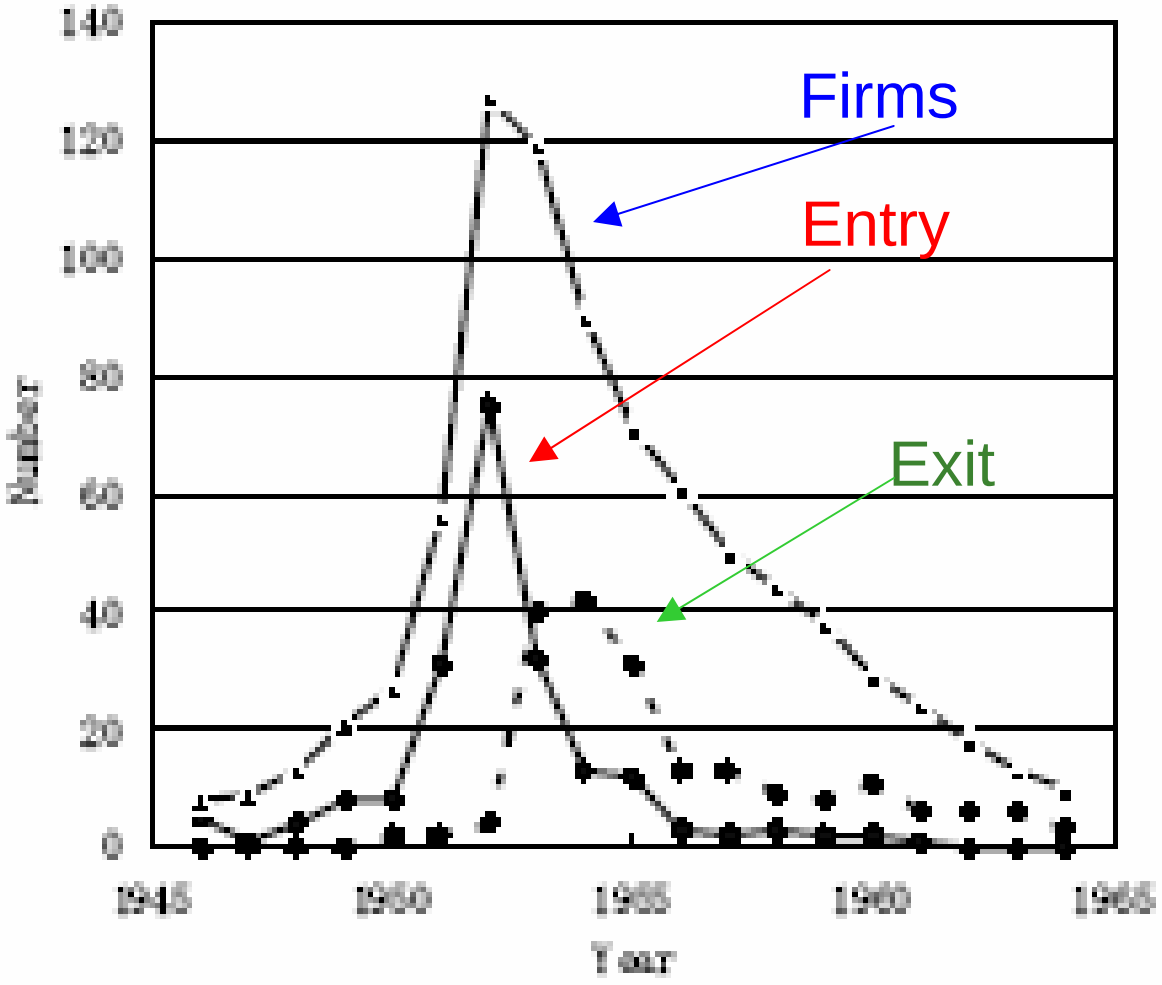
- Entrepreneurs that started their firms in the same year
- 90% of gains in 10% of entrepreneurs

Entrepreneurial rewards are highly skewed

- Other skewed distributions
  - Returns to innovations
  - Patent citations, academic citations
  - Musical compositions
  - Books
  - Comics books

- Many innovations are necessary in order to achieve a breakthrough
- In most cases, innovations will be failures

The motorcycle industry in Japan



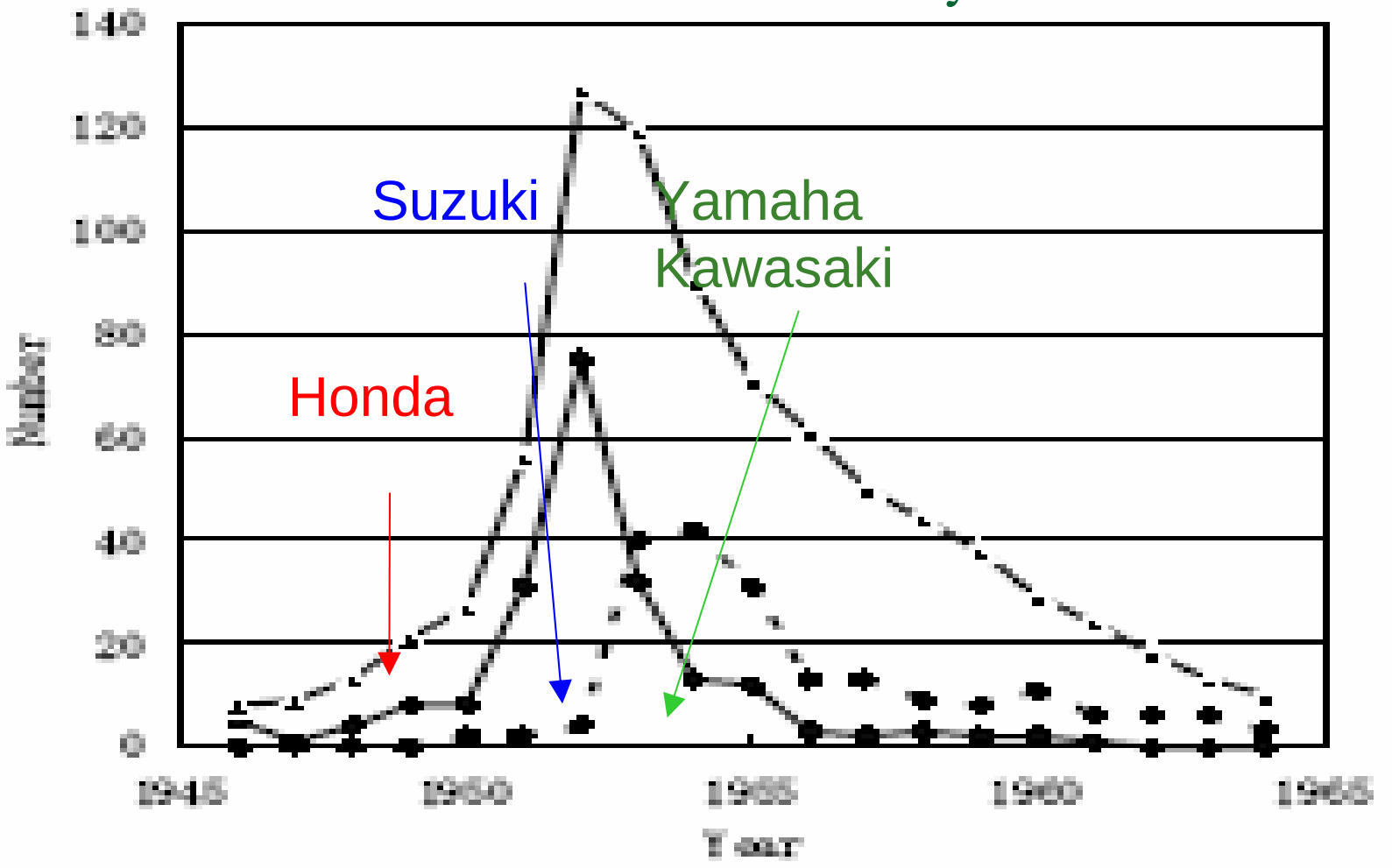
- Number of firms:
  - 20 in 1949
  - 120 in 1953-53
  - 20 again in 1962
- Most of the action took place in the 1950s

Source: Yamamura, Sonobe, and Otsuka 2005

Failure: implications

- Accept failure as normal
- Failing once does not imply subsequent failure
  - Experience from failure can be important for later success
- Limit responsibility of founders if fail

Most of the action took place in the 1950s: Market leaders entered early



Market leaders are experienced in "related" business

- Honda – piston rings
- Suzuki – looms
- Yamaha – musical instruments
- Kawasaki – shipbuilding

- **Leaders in U.S. industries (Klepper)**
  - TVs – radio firms
  - Penicillin – drug & chemical producers
  - Tires – rubber producers
  - Semiconductors – electronics firms

The motorcycle industry in Japan

Period	1948-53	1954-58	1959-64
Firm size (# motorcycles)	3,756 (6,130)	11,601 (17,370)	144,429 (281,097)
Years of operation	2.76 (2.04)	5.43 (3.26)	10.2 (4.38)
Pre-entry experience (%)	40	50	78

(Standard deviations in parentheses)

Source: Yamamura, Sonobe, and Otsuka 2005

Many successful innovators come from spinoffs

- Why spinoffs?
  - Good ideas don't get recognition in existing firms
- Spinoffs created by dissidents with good ideas
  - Financed by better judges of ideas
- Good firms
  - Better employees with better ideas
  - More and better spinoffs

Promote spinoffs and free movement of employees

- Employee non-compete covenants
- Trade secret law – narrow interpretation
- Indirect effects
  - Rent controls
  - Pension plans

Summary

- Entry, exit and mobility
  - much more than equilibrium adjustments
  - play an important role in increasing productivity and lowering prices
- Costs of inhibiting them can be substantial
  - There is a role for competition policy in “competitive industries”.
  - Caveat: I do not suggest that this is the most important aspect of Competition Policy in industries with market power

Summary of recommendations

- Market restrictions
  - Keep them low
  - Keep them identical for all firms
- Success is uncommon
  - Accept failure as normal
  - Limit responsibility of founders
- Promote mobility of employees