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I Z A
World of Labor
Evidence-based policy making

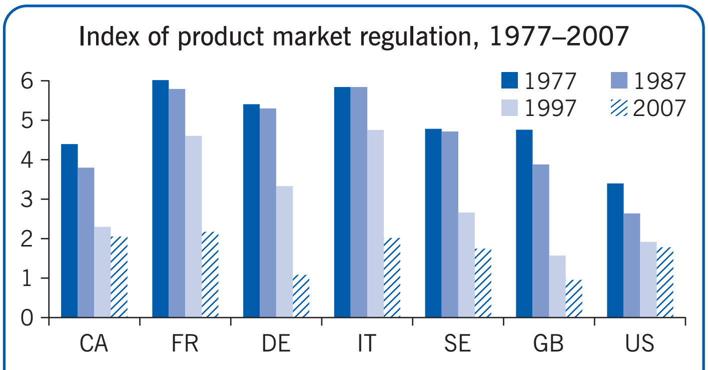
Do product market reforms stimulate employment, investment, and innovation?

Reducing entry barriers and increasing competition can be beneficial for the economy, under certain conditions

Keywords: product market reforms, employment, investment, innovation

ELEVATOR PITCH

Most OECD countries have recently introduced product market reforms with the objective of lowering barriers to entry and increasing competition in many sectors, such as telecommunications, utilities, and transport. The timing and extent of regulatory reform have varied significantly, starting in the US in the early 1980s and in the mid-1990s in many European countries. Will these developments improve economic performance in terms of creating jobs, fostering investment, and encouraging innovations—all of which are important factors for policymakers?



Note: Range of index: 0 to 6; higher values indicate stricter regulation.
Source: Based on Figure 1.

KEY FINDINGS

Pros

- Pro-competitive product market reforms generate significant employment in OECD countries when labor market policies are tight.
- Product market reforms generally lead to labor market reforms, enhancing the overall positive effect on employment.
- Reducing entry barriers significantly increases the investment rate, which is important because investment often incorporates technologies.
- Product market reform is likely to positively affect sectors that are close to the technological frontier, where incumbents, by innovating, can escape the threat of entry of new firms.

Cons

- It may take time for the positive effects of product market reform on employment to be felt and short-term employment losses can occur, generating opposition to the reform.
- With deregulation there are winners, but also losers. The concentration of losses may make reforms more politically difficult to implement.
- Evidence on the effect of product market reform on innovation is mixed; in sectors that are far from the technological frontier (i.e. not technologically advanced), the reduction of expected monopoly profits can hinder innovation.

AUTHOR'S MAIN MESSAGE

Product market reform stimulates firms' demand for labor and their willingness to invest. While this creates jobs in the long term, short-term effects are debatable. Favorable long-term employment outcomes are more likely if labor markets are rigid and are enhanced by product market deregulations that encourage labor market reforms. While empirical results suggest that lower entry barriers stimulate investment, evidence on the impact on innovation is mixed. Lower monopoly profits decrease the incentive to innovate, whereas greater competitive pressure forces incumbents to innovate more. The effect on innovation is more likely to be beneficial the closer firms in an industry are to the technological frontier.

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