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Between-Firm Redistribution of Profit in Competitive Industries: Why Labor Market Policies May Not Work

Non-Technical Summary

How important is the structure of the economy's production sector for designing the labor market policies? This paper draws attention to the empirical evidence reporting that different firms respond differently to the introduction of various labor market policies and argues that this heterogeneity of the firms' responses may have important implications for policy analysis if

- firms' entry into the economy is competitive;
- there are substantial differences in size or productivity between young and mature firms..

The main argument of the paper is illustrated using the example of targeted employment subsidies (paid to the firms for hiring disadvantaged, usually low-skilled, workers). Empirical studies document that large firms participate more actively in these subsidy programs than small firms do. At the same time, firm dynamics literature provides a broad evidence of the positive relationship between firms' size and age. These findings suggest that large and mature firms benefit from the introduction of the targeted employment subsidies, while small and young establishments may incur indirect cost. A theoretical analysis in this paper argues that such redistribution of profit from young to mature firms might decrease the value of entrants, discourage start ups and weaken the effects of the new government policy. In particular, a subsidy program that *increases* total employment in the economy with homogeneous firms, might actually *decrease* the employment level in the economy, in which the differences between young and mature firms are consistent with those observed in the data.

In more general terms, the analysis in this paper contributes to the literature by suggesting that

- if these are the mature firms that participate more actively in a new government policy and the differences (e.g. in size or productivity) between the young and mature firms are quite large, the expected positive outcomes of the new policy may be outweighed by the endogenous decrease in the number of operating firms;
- the heterogeneity between young and mature firms could serve as an important explanatory variable in the empirical studies evaluating the effects of various labor market policies.