

# Entry Regulation as a Barrier to Entrepreneurship

● Leora Klapper, Luc Laeven, and Raghuram Rajan

**Regulatory barriers against entrepreneurship hamper the creation of new firms, discourage the entry of small firms, and affect even older firms, which grow more slowly and to a smaller size**

Entrepreneurship is important for the continued dynamism of the modern economy and contributes to economic growth. Yet many countries put in place regulations that make it more difficult to start a new firm. In a new paper Klapper, Laeven, and Rajan look at the cost of meeting the regulatory requirements for setting up a limited liability company and study the effect of such entry regulations on the creation of new firms, the average size of firms that finally are able to incorporate, and the dynamism of incumbent firms.

The authors start by investigating the cross-country picture of the incorporation of new firms, using a comprehensive database of corporations across a large number of developed and transition economies in Europe. Some facts are striking. Italy, for example, with its myriad small corporations, might be expected to have tremendous incorporation of new firms. In fact, new corporations (those that are one or two years old) represent only 3.8 percent of the total in Italy. In contrast, the average for France, Germany, and the United Kingdom is 13.5 percent.

To study whether entry costs affect the extent of incorporation, the authors examine whether the share of new corporations is lower in an industry with a higher “natural” propensity for entry when the country has higher costs of complying with bureaucratic requirements for incorporation. They find that the rate at which new corporations are created in “naturally high-entry” industries is relatively lower in countries with higher entry costs, suggesting that these costs matter.

Interestingly, the costs matter most in richer countries and in countries that are not corrupt, where the regulations on the books are more likely to be enforced.

These findings suggest an explanation for the low level of incorporation in Italy: the average direct cost of complying with the bureaucratic regulations for registering a new corporation in Italy is 20 percent of per capita GNP—twice the average for other G-7 countries in Europe.

The authors next study the effect of bureaucratic entry regulations on the average size of entrant firms. Since the high entry costs are largely fixed, they should be reflected in a larger average size of entrants into high-entry industries in countries with high costs. The authors find that this is indeed the case. That means that such regulations not only discourage small firms from setting up, they also force others to grow without the protection of limited liability until they reach a scale at which they can afford the cost of incorporation.

If entry regulations indiscriminately screen out small young firms, constraints on their emergence should mute the disciplinary effects of competition, with older firms more likely to be lazy and less capable of enhancing productivity. Testing whether entry regulations affect the productivity growth of older incumbent firms, the authors find that value added per employee for older incumbents grows relatively more slowly in naturally high-entry

industries in countries with costly bureaucratic barriers. Thus costly entry regulations are a form of protection that has the most deleterious effect on the performance of seasoned incumbents.

Here, a comparison between Italy, with high entry barriers, and the United Kingdom, with low ones, is particularly telling. Across all industries, firms start out larger when young in Italy, but then grow more slowly—so that by age 10, firms in the United Kingdom are about twice as large as those in Italy. This suggests that Italy has small firms not because there is too much entry but because there is too little.

To check whether entry regulations proxy for other aspects of the business environment that are likely to have an impact on entry—such as financial development, labor regulation, and protection of intellectual property—the authors include these environmental variables interacted with the characteristics of the industry they are most likely to influence. The results show that these aspects of the business environment do matter, but primarily for the rate of incorporation, not for the size of entrants or the productivity

growth of incumbents. Particularly noteworthy is that the harmful effects of onerous entry regulations persist despite the inclusion of these other interactions.

*By hampering the creation of new firms, costly entry regulations serve as a form of protection. The absence of the disciplining effect of competition from new firms has real adverse effects*

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