Fixed Cost, Number of Firms, and Skill Premium: An Alternative Source for Rising Wage Inequality

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Abstract

The number of firms and the wage inequality increased in U.S. manufacturing industries after the late 1970s and early 1980s, when the so-called "Carter/Reagan deregulation" was implemented. This paper provides a possible theoretical explanation for this observed relationship between the number of firms and the wage inequality on the basis of fixed cost. By modifying a variety model, we show that lowering the fixed cost of entry increases the variety of inputs used by the final good. The skill premium then rises through variety-skill complementarity. Our model also shows that the size of a firm decreases and the real wage of low-skilled labor does not necessarily decline, which are compatible with U.S. observations.

Keywords: Fixed cost; The number of firms; Skill premium; Variety-skill complementarity

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1 Introduction

One interesting fact in regards to the U.S. economy is that both the number of firms and the skill premium showed a rising trend in U.S. manufacturing industries after the late 1970s and early 1980s. Note that firm size was decreasing while the number of firms was increasing and that the real wage of low-skilled workers did not show a declining trend despite the increase in wage inequality.[1]

A second interesting fact is that the timing of events which can lower the fixed cost of entry (such as entry deregulation and technological change) is similar to the timing of the increase in the number of firms and the skill premium. For example, the so-called "Carter/Reagan deregulation" was implemented in the late 1970s and early 1980s. Data indicates that this entry deregulation has been prevailing in U.S. product markets since the late 1970s: the index of entry costs in U.S. product markets remarkably decreased from 5.2 to 0.6 during the period 1978-1997 (Ebell and Haefke, 2006).[2]

Due to these similarities, we should no longer ignore the possible relationship between the fixed cost, the number of firms, and the skill premium. This, however, poses a theoretical challenge to us because no past research has related the number of firms to the skill premium. Most of the past research has related technological change (Katz and Autor, 1999; Berman et al., 1994; Krusell et al., 2000) or international trade (Feenstra and Hanson, 1996; Dinopoulos and Segerstrom, 1999; Acemoglu, 2003; Zhu and Trefler, 2005) to the skill premium. This paper, however, is the first to link the number of firms to the skill premium.[3]

We formulate a simple general equilibrium model to provide a possible theoretical explanation for the observed relationship between the number of firms and the skill premium on the basis of fixed cost. By modifying a well-known variety model, we

[1] The number of firms which is defined by the number of establishments in U.S. manufacturing industries increased from 358061 to 373548 over 1982-1997. The relative wage of high-skilled to low-skilled workers which is defined by the relative wage of non-production to production workers in U.S. manufacturing industries also increased from 1.58 to 1.88 over the same period. The size of a firm which is defined by (total employment)/(the number of firms) decreased from 53.37 to 48.40; the real wage of production workers in U.S. manufacturing industries which is deflated by the CPI slightly increased from 100 (1982=100) to 102.07 over the same period. The source of data is the U.S. Annual Survey of Manufactures (ASM). Note that the ASM uses census data for the number of establishments, and this census is conducted at 5-year intervals.

[2] Ebell and Christian (2006) calculate the index of entry costs by adding the entry delay (as a fraction of a year) and the fees (as a fraction of annual per capita GDP) and then converting to months by multiplying by 12 to obtain a composite entry cost measure. Many papers provide evidence on the costs of entry. For example, see Djankov et al. (2002).

[3] Many papers relate regulation/entry costs to labor market performance such as the size of employment. For example, see Boeri et al. (2000) and Pissarides (2001).

show that lowering the fixed cost in the intermediate sector increases the variety of inputs used by the final good. The skill premium then rises if we assume variety-skill complementarity. We also show that the size of a firm decreases and the real wage of low skill does not necessarily decline, which are compatible with the U.S. observations.

The rest of this paper is organized as follows. In Section 2, we formulate a two-sector variety model with fixed cost and show that our model can qualitatively explain the observed facts if we assume variety-skill complementarity. We finally conclude and mention future research in Section 3.

2 Model

2.1 The Ingredients of the Model

In this paper, we modify the standard one-sector variety model (Dixit and Stiglitz, 1977; Krugman, 1979; Dixit and Norman, 1980; Ethier, 1982) by extending the model to a two-sector model.

Consider an economy with a final good sector and an intermediate goods sector. There are two types of skills: high-skilled and low-skilled labor. Their endowments are given by $\bar{H}$ and $\bar{L}$, respectively. These skills differ in that the high-skilled labor can handle a variety of tasks but the low-skilled labor cannot.

The production side is as follows. The final good sector is perfectly competitive and non-traded. It uses a continuum $[0, n]$ of intermediate goods and the high skill. The technology is given by the following constant returns to scale production function:

$$y = \left[\left(\int_0^n x(j)^\rho \, dj \right)^{\epsilon/\rho} + H^\epsilon \right]^{1/\epsilon},$$

where y is the output of final good, $x(j)$ and H are the demand for differentiated intermediate good j and high skill, and the total number of variety is n. We assume that $\epsilon < 1$ and $0 < \rho < 1$. The elasticity of substitution between the varieties and high skill is given by $\sigma = 1/(1-\epsilon)$.

On the other hand, the differentiated intermediate goods sector is monopolistically competitive. Firms are symmetric and follow Cournot pricing rules. There is also free entry and exit. Each variety uses the low skill, and the technology of each variety

is given by the following increasing returns to scale production function:

$$x(j) = \left(\frac{1}{b}\right) \max\left[l(j) - f,\ 0\right], \forall j,$$

where $l(j)$ is the demand for low skill to produce each variety j, f is the fixed cost in terms of low skill, and b is the unit low-skill requirement.

The demand side is as follows. For simplicity, we focus on a representative consumer who has the endowments of high skill and low skill: $\bar{H}$ and $\bar{L}$. He or she consumes the final good. His or her utility function is given by:

$$u(c) = c,$$

where c is the quantity of the final good he or she consumes. His or her budget constraint is given by:

$$p_y c = w^H \bar{H} + w^L \bar{L},$$

where p_y is the price of the final good, w^H is the wage for the high skill, and w^L is the wage for the low skill.

The feasibility conditions for high-skilled labor and low-skilled labor are:

$$H = \bar{H},$$

$$\int_0^n l(j)\, dj = \bar{L}.$$

Finally, let us assume that a government can control fixed cost for firms in the intermediate goods sector. We note that a decrease in the fixed cost may be caused by technological progress as well as a policy such as entry deregulation.

2.2 Free Entry and the Skill Premium

First, we derive the free-entry number of firms $\hat{n}$ in the intermediate sector with the regulated fixed cost at $\bar{f}$.[4]

Given an arbitrary n, each producer of varieties facing the indirect demand by the final good sector maximizes the profit $p(j)\, x(j) - w^L b x(j) - w^L \bar{f}$ where $p(j)$

[4]In regards to the free-entry number of firms, Mankiw and Whinston (1986) is one of the most notable theoretical studies. They show that there is a tendency toward excess entry from a social standpoint in homogenous product markets and that product differentiation can reverse this tendency.

is the price of intermediate good j. By setting $w^L = 1$ as numeraire and using the symmetry $x(j) = x$, the output $x(n)$, price $p(n)$, and profit $\pi(n)$ of each variety corresponding to this n can be given by:

$$x(n) = \left[\left(\frac{b}{p_y n^{(\epsilon/\rho)-1} \rho} \right)^{\epsilon/(1-\epsilon)} - n^{\epsilon/\rho} \right]^{-1/\epsilon} H, \forall j;$$

$$p(n) = p = \frac{b}{\rho}, \forall j;$$

$$\pi(n) = (b/\rho) x(n) - b x(n) - \bar{f}, \forall j.$$

Since the price does not depend on the number of varieties n, the price when the profit of each variety becomes zero by the free entry and exit is also given by $p = b/\rho$, and the zero profit condition $p x(\hat{n}) - b x(\hat{n}) - \bar{f} = 0$ with $p = b/\rho$ gives the output of each variety, $x(\hat{n}) = \left(\bar{f}\rho\right) / [b(1-\rho)]$. The equality of labor demand and supply in the intermediate sector, $\hat{n}\left[b x(\hat{n}) + \bar{f}\right] = \bar{L}$, gives the free-entry number of firms $\hat{n}$:

$$\hat{n} = \frac{\bar{L}(1-\rho)}{\bar{f}}.$$

As we can see, lowering the fixed cost $\bar{f}$ is accompanied by an increase in the equilibrium free-entry number of firms $\hat{n}$.

Second, we derive the solutions in the final sector.

Let us solve the maximization problem for the final good sector by means of the following short-cut method. Define a new good

$$X = \left(\int_0^n x(j)^\rho \, dj \right)^{1/\rho}$$

and its price p_X. The profit of the final good sector now becomes:

$$p_y \left(X^\epsilon + H^\epsilon \right)^{1/\epsilon} - p_X X - w^H H.$$

By solving the cost minimization problem for the good X, we find that the price of X is:

$$p_X = \left(\int_0^n p(j)^{\rho/(\rho-1)} \, dj \right)^{(\rho-1)/\rho}.$$

By symmetry $p(j) = p$, this p_X becomes:

$$p_X = n^{(\rho-1)/\rho} p.$$

The market clearing condition for the final good and the first order conditions with respect to X and H then give:

$$w^H = p_X^{\epsilon} \left(\frac{\bar{L}}{\bar{H}} \right)^{1-\epsilon},$$

where $p_X = n^{(\rho-1)/\rho} p$. Since we have normalized $w^L = 1$, the relative wage of high-skilled to low-skilled labor—skill premium—is simply given by w^H.

Finally, by combining the solutions in the intermediate sector and in the final sector, we get the skill premium $w^H\left(\bar{f}\right)$ corresponding to the regulated fixed cost $\bar{f}$:

$$w^H\left(\bar{f}\right) = \left(\hat{n}^{(\rho-1)/\rho} p\right)^{\epsilon} \left(\frac{\bar{L}}{\bar{H}} \right)^{1-\epsilon}, \tag{1}$$

where $\hat{n} = \bar{L}(1-\rho)/\bar{f}$.

2.3 The Control of Fixed Cost, the Number of Firms, and the Skill Premium

We now see the possible relationship between the number of firms and the skill premium on the basis of fixed cost. From (1) in Section 2-2, we get the following lemma.

Lemma 1 *If the government decreases the fixed cost $\bar{f}$, then the skill premium w^H decreases if $\epsilon > 0$, remains unchanged if $\epsilon = 0$, and increases if $\epsilon < 0$.*

Proof. Differentiating (1) in Section 2-2 with respect to $\bar{f}$ gives:

$$\frac{dw^H\left(\bar{f}\right)}{d\bar{f}} = \overbrace{+ \text{ or } 0 \text{ or } -}^{\epsilon} \overbrace{\left(\hat{n}^{(\rho-1)/\rho} p\right)^{\epsilon-1} \frac{(\rho-1)^2}{\rho} \hat{n}^{-1/\rho} p \left(\frac{\bar{L}}{\bar{H}} \right)^{1-\epsilon} \bar{L} \bar{f}^{-2}}^{+}.$$

■

From the above lemma, we get the following proposition.

Proposition 2 *Suppose that the government decreases the fixed cost. Then the number of firms increases. The skill premium, the real wages of high- and low-skilled workers, and the size of a firm also change as follows.*

ε	Skill Premium w^H	Real Wage of H	Real Wage of L	Size of Firm
$\varepsilon > 0$	-	+	+ +	-
$\varepsilon = 0$	Unchanged	+	+	-
$\varepsilon < 0$	+	+ +	+	-
	+	+	-	-

Note : "+" and "-" refer to an increase and a decrease, respectively. "+ +" refers to a greater increase than "+."

Proof.

1. The signs of a change in w^H are obvious by Lemma.
2. y and w^H/p_y $(= MPH)$ are positively correlated. The decrease in fixed cost causes $y \uparrow$ and thus $w^H/p_y \uparrow$.
3. $w^H \downarrow$ is caused by $w^H/p_y \uparrow$ and $w^L/p_y \uparrow\uparrow$.
4. $w^H \uparrow$ is caused by $[w^H/p_y \uparrow\uparrow$ and $w^L/p_y \uparrow]$ or $[w^H/p_y \uparrow$ and $w^L/p_y \downarrow]$.
5. The size of a firm in the intermediate sector, $\bar{L}/\hat{n}$, decreases due to $\hat{n} \uparrow$. ■

In this proposition, we have shown that lowering the fixed cost $\bar{f}$ for firms in the intermediate sector increases the variety of inputs $\hat{n}$ used by the final good. Then the skill premium w^H rises if $\epsilon < 0$, that is, if the varieties and high skill are complements.[5] We have also shown that the size of a firm decreases and the real wage of low skill does not necessarily decline, which are compatible with U.S. observations. We note that the decrease in the fixed cost is here caused by the control of the government, though it can also be caused by technological progress.

[5]Here we define the case $\epsilon < 0$ $(\sigma < 1)$ as the case in which the varieties and the high skill are complements. In some papers, the number of inputs plays a role in a related way. Blanchard and Kremer (1997) define the index of complexity which relates the increased number of inputs to more complexity in production processes. Kremer (1993) shows that higher skill workers will use more complex technologies that incorporate more tasks.

3 Conclusion and Future Research

We have shown some interesting facts in regards to the number of firms, the skill premium, and the fixed cost in the U.S. after the late 1970s and early 1980s. Section 2 has shown that our simple model can qualitatively explain these U.S. observations if we assume the variety-skill complementarity. This indicates that the number of firms can be one possible source of the factors contributing to the increased skill premium in the U.S. after the late 1970s and early 1980s.

Of course, there are several next logical steps for future research since this paper is only the first step to add an alternative theoretical explanation for the rising inequality to the literature. First, it would be interesting to look at cross-country data on fixed cost such as entry cost, the number of firms, and the skill premium in order to find a more robust relationship across countries (Japan, EU, etc.).

Second, we can extend this closed economy model to a two-country model. We can thus analyze the possible effects of domestic entry policy on the skill premium in a foreign country through variety trade.

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