FALL 2008 BROWN BAG SEMINARS

UNIVERSITY OF HOUSTON

Center for PUBLIC POLICY

Trade Reforms and Market Selection: Evidence from Manufacturing Plants in Colombia

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ABSTRACT: We use plant output and input prices to decompose the profit margin into four parts: productivity, demand shocks, mark-ups and input costs. We find that each of these market fundamentals are important in explaining plant exit. Then, we use differences across sectors in the change in tariffs over time following the trade reform in Colombia to assess whether the impact of different components of the profit margin on plant exit changed with increased international competition. We find that greater international competition increases the marginal effect of productivity, and other market fundamentals, on plant exit. To assess the implications for aggregate productivity, we conduct a dynamic simulation to compare the distribution of productivity with and without the trade reform. We find that the improvements in market selection from trade reform help to weed out of the market the least productive plants, and increase average productivity. Moreover, we also find evidence that trade liberalization contributes to increasing the growth rate of productivity of incumbent plants as well as to a general improvement in the allocation of activity within industries.

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