

This paper studies the short-run effects of structural reforms that cut entry costs for firms. We provide novel empirical evidence on the response of firms' entry, employment, and exit behavior. To do so, we use as a natural experiment a reform in Portugal that significantly cut entry time and costs. We find that the reform increased entry and employment by 25% and 4% per year, respectively. Moreover, around 60% of the increase in employment came from incumbents expanding their size, with most of the rise occurring among the firms that were the most productive before the reform. Overall, the reform had an expansionary impact in the short run. Standard models of entry, exit and firm dynamics, which assume a constant elasticity of substitution, are inconsistent with our findings about the response of incumbents to the reform. We show that a model with heterogeneous firms and variable markups accounts for our evidence. In this framework, the most productive firms increase their labor demand following a rise in the level of competition.