

To grow or not to grow, that is the problem

A country with a high business start-up rate and a large number of small and medium-sized enterprises (SMEs) is usually a sign of great dynamism, flexibility and entrepreneurship. But warning bells start to sound when the SMEs overwhelmingly dominate the production fabric and the number of large firms becomes almost inconsequential. In Spain, SMEs dominate the business structure much more than in any other similar country. Moreover, this predominance has remained constant over time, in spite of the high start-up and failure rate of firms. What lies behind this anomaly?

One possible explanation would be if the sector-based specialization of Spain's economy were tipping its business composition much more towards micro-enterprises and small firms. For example, the relative weight of industries such as hotels and restaurants and also tourism, construction and real estate business, which usually have smaller firms, might be affecting the final result. However, as explained in the box entitled «Companies and productivity: a matter of size», the bias towards small firms in Spain can also be found in manufacturing, a sector that is much more likely to have larger companies.

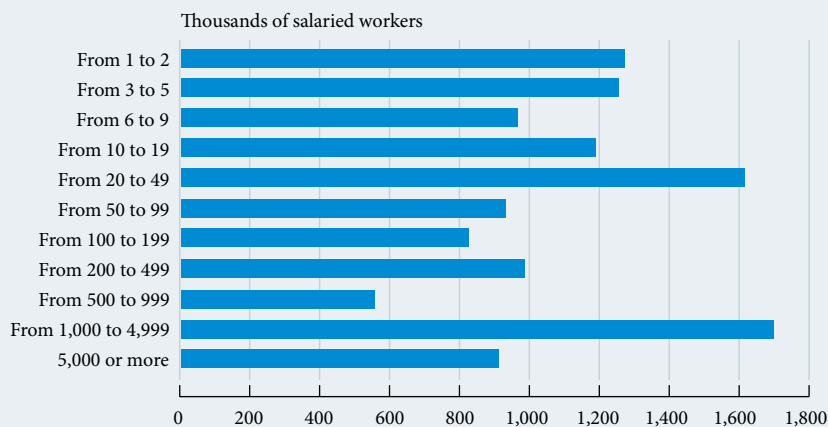
Alternatively, the predominance of small firms might also be due to the institutional framework in place: labour market regulations, bureaucracy, disparate rules at different administrative levels, legal uncertainty, etc. These elements have a direct effect on productivity but also often act as a brake on a company's growth, which can also have an indirect effect on productivity itself. On occasion, some specific policies aimed at supporting SMEs, such as regulatory or fiscal exemptions or less demanding requirements (in terms of accounting and availability of information) can become obstacles to these firms becoming bigger. This happens when a regulation that aims to alleviate possible financial, fiscal or labour disadvantages specific to SMEs actually discourage these firms from growing since they believe that the benefits they lose are not compensated by being able to do business at a larger level.

This possible «perverse» effect of policies aimed at SMEs is not easy to identify but available evidence suggests that this actually occurs to some extent. The graph below provides some indication of this: it estimates the breakdown of the salaried workforce in the private sector in Spain at the beginning of 2011 (just over 12 million people including public corporations, according to the labour force survey of the National Institute of Statistics) by company size, as provided by the Central Company Directory at 1 January 2011, again from the National Institute of Statistics. A breakdown of the number of workers by company size would be expected to follow a regular pattern. However, a bias can be observed that leads these workers to be concentrated at the company sizes of 20 to 49 workers and 200 to 499 workers. Of note is the fact that, in both cases, the previous and next levels have a much lower number of salaried workers. Although this exercise is very limited and merely an estimate, the polarization observed coincides with the levels pointed out by or included within the definitions given, in conceptual and normative terms, to define SMEs in Spain and in the European Union. A small enterprise is understood to have up to 50 employees while a medium-sized enterprise has between 50 and 250 employees.

The suspicion raised by this initial examination of the data, namely that some factors of a regulatory or normative nature must be discouraging companies from changing from a small to a medium-sized firm or from a medium-sized to a large firm, i.e. company growth, is backed up by the findings from a number of recent studies in the field of economic research. In a study that compares the experience of different European

BREAKDOWN OF SALARIED WORKERS BY COMPANY SIZE: SUSPICIOUS BIASES

Number of salaried workers by company size



SOURCE: Own calculations based on the labour force survey and the Central Company Directory (National Institute of Statistics).

countries, Kumar, Rajan and Zingales (1999)⁽¹⁾ identify a positive correlation among better institutions, in their case measured as the efficiency of the judicial system and company size. Similarly, Santaló and Marcos (2010)⁽²⁾ have found, for the particular case of Spain, a negative correlation between regulatory intensity in the market of goods and services and the percentage of firms with more than 200 employees. Their study is based on an econometric analysis that compares the impact of regulatory differences in the different autonomous communities on the propensity to have large firms. On the other hand, a series of recent studies also identify a negative association between less demanding fiscal requirements for small-sized enterprises (compared with large ones) and company growth.⁽³⁾ In Spain's case, Almunia and López (2012)⁽⁴⁾ have found evidence of fiscal regulation affecting the distribution of company size within the business fabric. With regard to advantages for small firms in the labour area, the available evidence also points to this being detrimental to company growth (see the box entitled «Does labour regulation allow company growth?»).

There are many policies in Spain to support small and medium-sized enterprises, promoted both at the level of state as well as autonomous community and even municipality. They aim to boost SMEs in those areas where size conditions competitiveness or the generation of profit, such as financing, innovation, internationalization, the adaptation of labour resources or taxation, as well as actively promoting new start-ups and entrepreneurship. Taking into account the fact that the evidence suggests a company's size is one of the most decisive factors not only in its chance of survival but also in terms of its productivity and capacity to successfully break into foreign markets, greater emphasis should be placed on schemes that help companies to grow in size. When all is said and done, this is still an appropriate strategy to tackle these difficult economic times, in which productivity and competitiveness have become crucial.

(1) Krishna B. Kumar, Raghuram Rajan and Luigi Zingales (1999), «What Determines Firm Size?», NBER working paper series no. 7208; Cambridge: National Bureau of Economic Research.

(2) Santaló, J. and F. Marcos (2010), «Regulation, Innovation and Productivity», IE Business School Working Paper, WP 10-04.

(3) See, for example, Dharmapala, D., Slemrod, J. and J.D. Wilson (2011), «Tax policy and the missing middle: Optimal tax remittance with firm-level administrative costs», *Journal of Public Economics* 95 (9-10).

(4) Almunia, M. and D. López (2012), «Corporate Tax Evasion in Spain», Mimeo.

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