Policy brief

2006 | January 2012

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International Growth Centre

Creating a Data Legacy for the IGC Program

In brief

- We have investigated measures of firm organization across countries focusing on the heterogeneity of firms. The question is how policies shape the organization of firms and how this, in turn impacts on overall economic performance.
- Our paper (Garicano, Lelarge and Van Reenen, 2012) lays out a methodology for examining the impact of size-related policies on aggregate output.
- Most countries have size-related policies, for example regulations that increase firing costs when firms are larger than a certain number of workers, lower tax rates for SMEs, tougher environmental standards for large firms, etc.
- These policies have the unintended consequence of discouraging small firms to grow and may be responsible for the "missing middle" in developing countries (i.e. the relative absence of medium sized firms and the preponderance of very large and very small firms compared to more developed countries.
- We show that the cost of one such policy (relating to firing costs when firms reach 50 employees) is around 1% of GDP – a nontrivial amount.
- The implication is that there are substantial costs caused by the regulation. It also demonstrates that policies that favour SMEs may create "too many" small firms by depressing wages and taxing growth.
- Policy makers may consider a more level playing field for regulations without size-related distortions. The work should be of interest to entrepreneurs and policy-makers in all countries.

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Background: Firm Size Distortions and the Productivity Distribution

"We decided to focus on one important aspect of firm organization, the size and productivity distribution"

This project began by auditing all existing firm-level databases on organization. Our previous report has described these datasets and came to the disappointing conclusion that only the Bloom, Sadun and Van Reenen (2012) type of data had the comparable representative cross country data needed to make robust conclusions on direct measures of organizational practices. We are pursuing our collection and distribution of such datasets in developing and developed countries (see http://worldmanagementsurvey.org/).

We decided to focus on one important aspect of firm organization, the size and productivity distribution in order to make progress. This is where comparable cross country on indirect measures of organization (size, productivity and their covariance) are frequently available. We develop our methodology of showing the impact of size-contingent regulations in a country where the universe of firms is available and where a strong regulation bites when firms become bigger than 50 employees (France). We show that the regulation has a set of clear empirical and welfare implications that can be easily tested on the data.

Policy Implications

Size – related regulations:

- **Distort the size distribution** so that there is a bunching of firms at the regulatory threshold. This means that some firm who would have been larger choose to stay small in order to avoid the extra regulatory cost. In other words productive firms are much smaller than they would have been in the absence of the regulation and this reduces overall productivity and output
- **Have a direct effect that reduces the size of very productive firms** who choose to pay the cost and grow to be larger than the size threshold. For example, if firing costs increase when firms cross 50 employees, there will be some firms who are so productive they will stay large but have to pay the "tax" of being large and so will hire fewer workers. This means that even very large firms are smaller than they otherwise would have been and this reduces output overall.
- **Depress the level of wages**, as some of the cost of the regulation is borne by workers
- The wage-depressing effect has a positive effect on small firms below the regulatory cut-off. First, some workers will (inefficiently) choose to start up small firms as the returns to being an employee are depressed. Second, the smaller firms below the regulatory threshold has lower labour costs so will be larger than the undistorted world.

Overall, we calculate substantial effects (one percent of GDP) from a single labour regulation in France. The methods we use could be used in any country where there are size-related regulations. Policy-makers could use this in order to figure out the cost of the regulation and consider whether or not these costs could be worth the putative benefits.

Implementation

"Overall, we calculate substantial effects (one percent of GDP) from a single labour regulation in France"

- Our method can be implemented on any country where there is information on the size distribution.
- Do an audit of size-related regulations.
- Analyze the costs of these using our methodology.
- Consider whether to abolish the regulation or change the point at which it begins (e.g. remove more small firms from the regulatory threshold)

Dissemination

Probably business and finance ministries

Further Reading

- Our paper was featured in the Economist's economics pages "Free Exchange" http://www.economist.com/node/21548923
- Bloom, Nick, Sadun, Raffaella and John Van Reenen (2012) "The organization of firms across countries'' CEP Discussion Paper No. 927, http://cep.lse.ac.uk/pubs/download/dp0937.pdf, Forthcoming, Quarterly Journal of Economics

About the authors

John Van Reenen is a Professor in the Department of Economics and Director of the Centre for Economic Performance at the London School of Economics. He also serves of the Editorial Board of the Journal of Industrial Economics.He has published widely on the economics of innovation, labour markets and productivity. He was a senior policy advisor to the Secretary of State for Health, Downing Street, and other parts of the UK government, a partner in the economic consultancy, Lexecon, and until 2003 Professor of Economics at University College London (UCL).

The International Growth Centre (IGC) aims to promote sustainable growth in developing countries by providing demand-led policy advice based on frontier research.

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