

## **IGC Contract RA-2009-06-024**

Developing and Analyzing Firm-Level Indicators on Productivity and Reallocation

Date: February 28, 2011

John Haltiwanger, University of Maryland, NBER, IZA

Eric Bartelsman, Vrije Universiteit Amsterdam, Tinbergen Institute, IZA

### ***Policy Motivation for Research***

Productivity growth is the main driver of long-run increases in per capita income and welfare. Understanding the sources of productivity growth and the effect on policy on growth may provide for improvements in growth-oriented policy. Recent research has suggested that multiple paths to aggregate productivity must be distinguished: improvements at the firm-level, improvements in resource allocation across firms that differ in productivity, and entry and exit of firms. Our project aims at providing a method to measure these different components in a harmonized manner across countries, and in finding methods to analyze these data in order to identify the effects on productivity growth of cross-country differences in policy.

### ***Policy Impact***

Our work may provide a framework for evaluating the effect of changes in policy and economic institutions within a country, by comparing the impact of these changes on dynamics of productivity and resource use at firms in the country under study (treatment), as compared to firm-level dynamics in other countries (control). One of the main shortcomings in assessing the effect of policy using only information from one country, is that one cannot observe firms that have decided not to produce in the given institutional and policy setting.

### ***Audience***

We hope that our work will encourage national statisticians to compile harmonized indicators for many countries, using the methodology and program code we have supplied. We would be very happy if policy makers would commit to evaluating the macro-economic impact of policy changes by comparing the effects on firm dynamics within their country with firm dynamics seen elsewhere. We expect researchers will take our ideas and our data to improve the modeling of firm dynamics and improve upon the methods to measure such dynamics at the firm level.

### ***Implications***

The main findings from our cross-country datasets and analytical research may be summarized as follows:

- Firms are enormously heterogenous. Entrepreneurs and managers in market economies generate a wide variety of choices in many dimensions: product type, quality, price, choice of inputs and production processes, and outcomes in terms of productivity and profitability. Policy makers may only want 'the best producer', but in any country we see a wide distribution. Even in well functioning economies, there is a wide distribution given the economic frictions associated with moving resources to the highest valued use. But it also appears that policy distortions widen the width of the distribution as well as the extent to which resources move to the best firms.
- A 'level playing field' allows firms to make decisions based on their technical capabilities and demand for their products instead of on profitability that is affected by policy. We find that our measure of this 'level playing field', namely the correlation between productivity and firm size, has improved during the 1990s in the transition economies. We estimate that this may have reduced the gap between per capita income in these countries and the richest OECD members by about 10 percentage points.
- The amount of labor market turnover, hiring and firing, in a country is affected by labor market regulations. This seemingly obvious result often is not found in cross-country settings because of difference across countries in industry composition, but especially in firm age and size. When controlling for these characteristics in our harmonized cross-country dataset, we confirm the theory that higher hiring and firing costs reduce job turnover, and thereby the speed of reallocation needed to adapt to shocks and changing economic trends.
- The type of firms that produce in a particular country depend on the policy and institutional environment. While policy makers may now be accustomed to the fact that the tax base responds to the tax rate, it may be less obvious that the firms you do not see in your economy may not be there for policy-related reasons. We find that in the transition economies, distortions to profitability may often lead otherwise productive firms to exit the market. In another study, comparing across EU countries, we find that fewer workers are allocated to industries which would benefit most by adopting ICT in those countries where employment protection is more stringent. We back up this empirical finding with a causal mechanism, by modelling the choice of firms to open vacancies in low-tech versus high-tech industries and estimating the model parameters using information built up from our harmonized cross-country firm-level indicators. Similar studies could be used to re-visit the old question of the 'missing middle', or lack of medium-sized firms, or other anomalies found in comparing the cross-country datasets.

### ***Brief Summary of Research***

Our project has involved collecting, organizing, and analyzing a harmonized cross-country dataset of indicators describing the birth and death of firms, and the development of output and input growth among firms over time. These indicators can be used to inform a researcher on the parameters underlying models of firm dynamics. These models may be used to simulate the effects of various policy changes related, for example to fairness in tax collection, bankruptcy laws, or infrastructure decisions. In one of the research papers prepared for IGC, we assess the importance of cross-country differences in the business environment as perceived by firms, and describe how this can be used to identify the effects of these differences on the developments of output and productivity of firms. Figure 1 shows how these perceptions may vary systematically across firms by size.

### ***Implementation***

Our analytical work and computer code may be used by statisticians in the IGC countries to add harmonized indicators from their own firm-level data sources to the cross-country dataset. These may then be used to find out how their own policy environment, in comparison with that in reference countries, differentially impacts the development of firms' output and productivity.

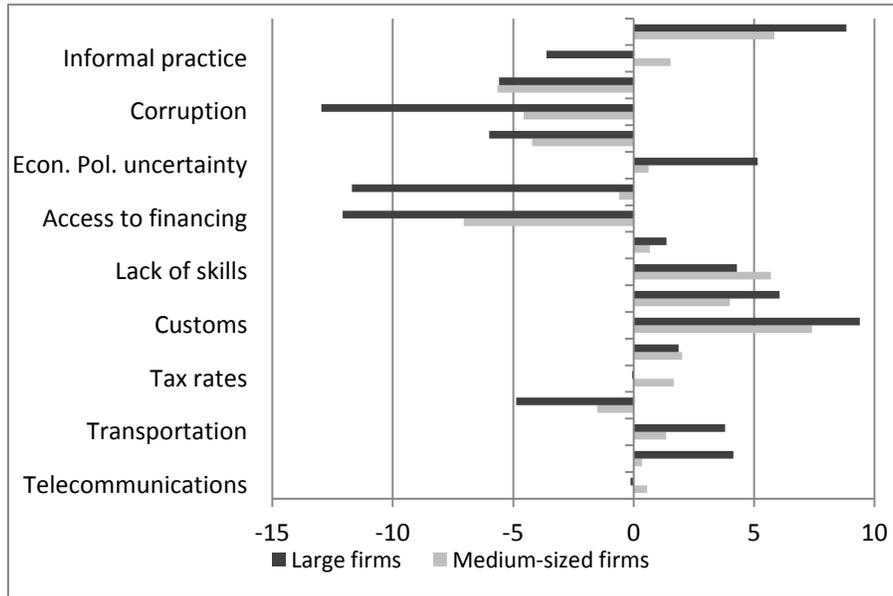
### ***Further Readings***

**Bartelsman, Eric J., John Haltiwanger, and Stefano Scarpetta**, "Cross country and within country differences in business climate", *International Journal of Industrial Organization*, 28 (July), 2010.

**Figure 1. Perceived constraints to the operation and growth potential by firm size**

(medium-size (20-100) and large firms (100+) versus small firms (fewer than 20 employees))

**Panel A: Latin America and Caribbean region**



**Panel B: Europe and Central Asia region**

