



Business demographics and dynamics in Europe

Trends in the composition of the company landscape

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The crisis in the euro area has left its mark on the corporate landscape. Nearly all the EMU countries have seen aggregate company numbers fall over the past few years. Insolvencies and voluntary liquidations have reached record levels, while the number of start-ups has decreased and young enterprises have often had poorer chances of survival.

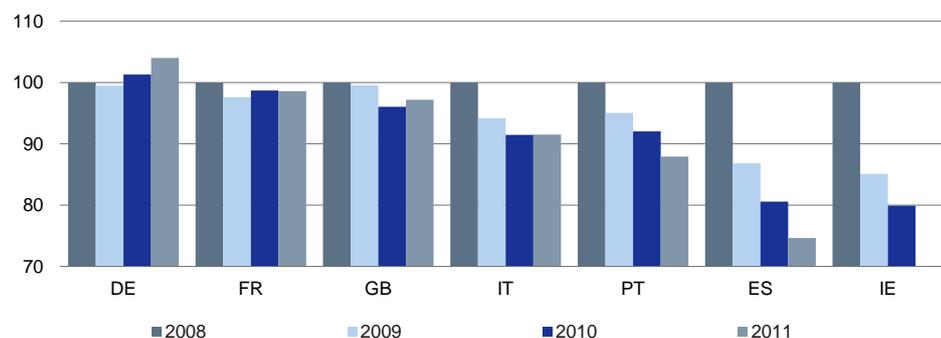
Small and medium-sized enterprises (SMEs) on the eurozone's periphery were hit particularly hard by the crisis. After all, SMEs rely much more heavily on domestic economic growth than do major companies with international operations. The number of firms with 10 to 250 employees has decreased much more sharply in the crisis countries than has the number of large companies, while the number of micro enterprises with less than 10 employees has remained relatively stable.

At the beginning of the crisis a severe demand shock triggered a sharp drop in the number of firms, especially in Ireland and Spain but also in Portugal and Italy. Moreover, as the crisis progressed the funding conditions for SMEs gradually worsened. From 2011 on substantial funding gaps emerged – both between countries (EMU core vs. the periphery) and between company categories (SMEs vs. large companies).

One topic that ought to be on the political agenda, apart from greater international diversification and better funding access for SMEs, is the elimination of structural obstacles to growth. Regulatory obstacles can hamper the development of a competitive corporate landscape and ultimately result in negative employment effects.

Crisis triggers significant decline

Number of enterprises with at least 10 employees; holding companies excluded; 2008=100



Sources: Eurostat, Deutsche Bank Research

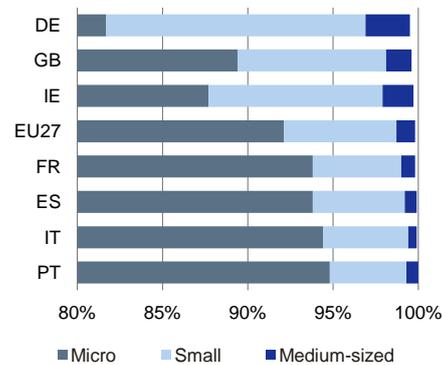


SMEs dominate the European economy

SMEs dominate Europe's corporate landscape

1

As % of total number of enterprises, 2012



Sources: European Commission, London Economics

The crisis in the euro area has left a noticeable imprint on Europe's corporate landscape. Owing to the difficult economic environment company insolvencies and liquidations have reached record levels in Europe. At the same time, fewer new companies have been established. Moreover, they have been confronted with poorer growth prospects and less chances of survival than in "normal" times. Furthermore, in many countries the funding conditions for small and medium-sized enterprises (SMEs) have worsened more than those for large companies. However, these trends differ very considerably across the member countries of the eurozone.

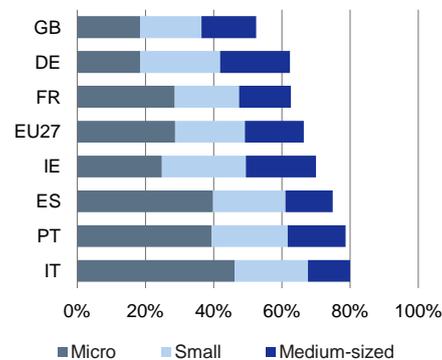
For the sake of simplicity SMEs are often referred to as a unit without allowing for the huge degree of heterogeneity within this category. The majority of SMEs are owner-operated and have far fewer than 10 employees. This category of enterprise differs fundamentally from larger SMEs, which have a greater focus on exports, compete with large multinationals and are often among the market leaders in their particular niches. Hence, to obtain a more detailed picture of current developments in Europe's corporate landscape it makes sense to examine SMEs separately according to their size. The European Commission gives a breakdown of SMEs using the following definition:

- **Micro enterprises:** fewer than 10 employees, less than EUR 2 million revenue or balance sheet total per year
- **Small enterprises:** 10 to 49 employees, less than EUR 10 million revenue or balance sheet total per year
- **Medium-sized enterprises:** 50 to 249 employees, less than EUR 50 million revenue or less than EUR 43 million balance sheet total

SMEs account for over 60% of employment in the EU

2

As % of total employment, 2012



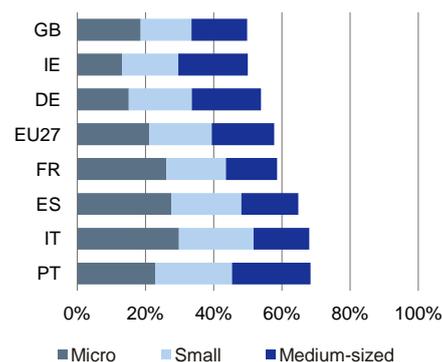
Sources: European Commission, London Economics

Only independent firms are deemed to be SMEs; the European Commission definition specifies that this condition is only met when less than 25% of the firm's shares belong to a different company. Like the ECB and most of the national central banks and statistical offices we also adopt this definition, as long as the corresponding data are available. The German "Institut für Mittelstandsforschung" (IfM, a research institute focusing on the "Mittelstand", or SMEs) defines "medium-sized" enterprises as those with 10 to 499 employees and revenue of up to EUR 50 m.¹ There is considerable overlap between the two definitions, but for the individual firms it makes a difference whether they still fall under the EU's SME definition since, among other things, this is linked to the eligibility for many subsidy programmes.

SMEs generate more than 50% of value added in the EU

3

As % of total value added, 2012



Sources: EU Commission, London Economics

SME performance is of particular interest because small and medium-sized enterprises play a dominant role in many EU countries. In 2012, some 99.8% of companies across the EU were categorised as SMEs; the share of micro enterprises with fewer than 10 employees came to 92.1%. All in all, the SME sector in the countries examined here provided jobs for between 52.4% (United Kingdom) and about 80% (Italy) of all employees. The SME share in value added was smaller, by contrast, ranging from 49.8% in the UK to 68% in Italy (EU-27 average: 57.6%). As value added per employee evidently increases with company size, an economy featuring mostly micro and small firm structures therefore tends to be disadvantaged in terms of aggregate efficiency vis-à-vis an economy dominated by larger companies.

¹ According to the IfM classification, 99.6% of all companies in Germany are SMEs, and according to the European Commission 99.5%. The SME share in overall employment totals 59.4% and 54.1%, respectively.



Business demographics: Recent developments

The number of active firms per se is not necessarily a meaningful indicator for the state of the business sector. In particular, an economic structure with many small companies may also suggest that it has not yet undergone an overdue process of consolidation. If a high degree of competitive pressure ensures that unprofitable firms exit the market or that economies of scale are achieved via mergers, a reduction in the number of companies can indeed result in aggregate productivity gains. However, it is a problem if there is an increased exit rate not among the micro enterprises but mainly among larger SMEs with growth potential. In the countries of southern Europe, where small and micro firms still have a disproportionately large role for the economy, this is precisely what has happened.

We observe across almost all of the countries considered in this study that the medium-sized segment sustained greater losses in the course of the crisis, while the firms at the upper and lower ends of the scale were better able to hold their own. Large companies partly compensated for the low growth in the eurozone by boosting their exports and were less dependent on domestic bank lending. By contrast, micro enterprises are less susceptible to cyclical ups and downs, expanding less in upswing phases than larger companies but also contracting less markedly in downswing phases. They are only partially comparable with the small and medium-sized enterprises. According to Eurostat, a micro enterprise employs merely two persons on average in the EU; over 30% do not have any other employees and roughly 70% have fewer than five. However, the comparatively stable performance of the micro enterprises in southern Europe can presumably also partly be explained by the fact that many small and medium-sized enterprises have shrunk and have had to lay off employees, so that they slipped into the bottom category. No detailed figures are available for transitions between the size categories, though.

In the following we take a closer look at the country-specific features.²

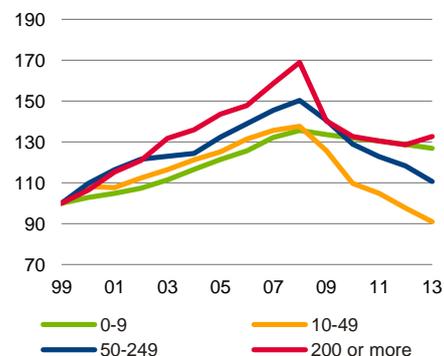
Spain

From the mid-1990s Spain underwent a phase of strong expansion that was driven primarily by the booming construction sector. Taking the 1999 level as the basis, the total number of companies climbed by approximately 35% until it peaked in 2008. Expansion was particularly noticeable among the large companies with 200 or more employees, with their number soaring by nearly 70% up to 2008 (chart 4).³ Since then, however, there has been a slump in absolute terms in nearly all of the categories of company apart from micro enterprises, where the decline remained within limits at about 10%. By contrast, the number of small enterprises fell from 137% of the 1999 level to 90% between 2008 and 2013, and the number of medium-sized enterprises from 150% to 110%. The trend in these size categories has been persistently

Number of enterprises in Spain

4

All sectors, 1999=100, by number of employees

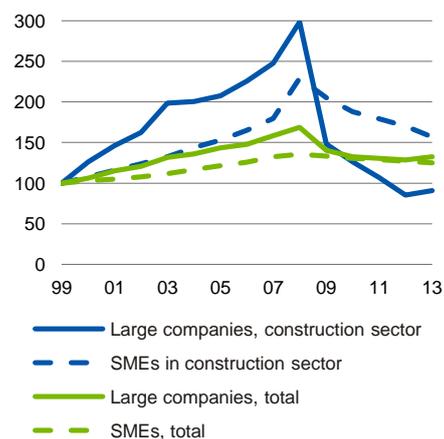


Source: INE

Spain: Construction boom and bust

5

Number of enterprises; 1999=100



Source: INE

² The quality of the data on company numbers and dynamics, and their timeliness, vary considerably in Europe. Eurostat publishes harmonised data with a time lag – at present most of the information available merely goes up to 2011. In the following, to better reflect current developments, we rely mostly on data from the national statistical offices. However, there are major differences in the recency of the data releases here too. For example, the United Kingdom and Spain have already released company figures for 2013, other countries, by contrast, only up to 2011. Greece is excluded from this report since neither Eurostat nor Greece's statistical office publishes comparable information on company numbers and dynamics.

³ The Spanish statistical office, INE, gives a more detailed breakdown of the categories than most of the other countries; however, it diverges from the otherwise common classification of large companies (250 and more employees). Instead, INE reports on the size categories “200-500 employees” and “500 and more employees”.

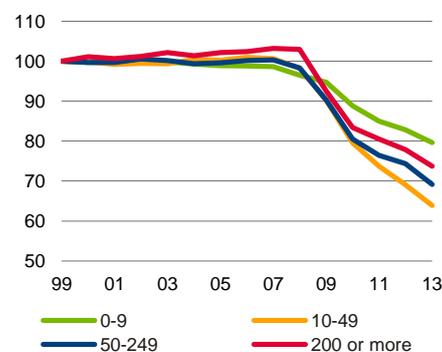


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Spain: Manufacturing hit hard

6

Number of manufacturing companies; 1999=100



Source: INE

negative to date, while the large companies appear to be reaching the end of the downward spiral.

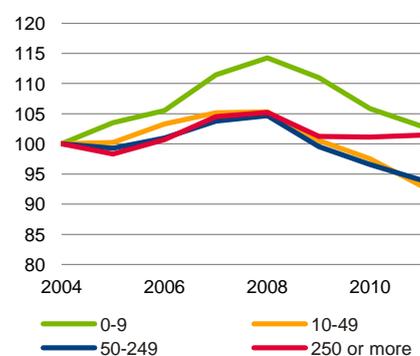
The special role played by the construction sector in Spain's macroeconomic performance is also reflected impressively in the country's corporate demographics. By 2008, the total number of firms in this sector had more than doubled in relation to the 1999 level, and that of the large construction companies in fact tripled (chart 5). The subsequent correction was so pronounced, however, that the number of SMEs has meanwhile fallen below the 1999 level. In contrast to the construction sector, the number of manufacturing companies remained virtually constant in the period up to 2008 (chart 6). This is remarkable insofar as the high level of building activity also had a large demand effect on many branches of manufacturing which, however, was obviously mostly met by the existing companies and through imports. By contrast, the bursting of the property bubble also affected manufacturing and, here too, the small and medium-sized enterprises were the ones hit the hardest.

So, all in all, the trends to be observed for SMEs and large companies in Spain have been extremely diverse. The end of the recession provides hope that there may be a turnaround in the business sector before long. Within the sector, the recently observed shift from small and medium-sized enterprises towards bigger companies could continue at least for the time being, though, as the SMEs are facing a difficult funding situation.

Portugal: Number of enterprises

7

All sectors, 2004=100, by number of employees



Source: INE

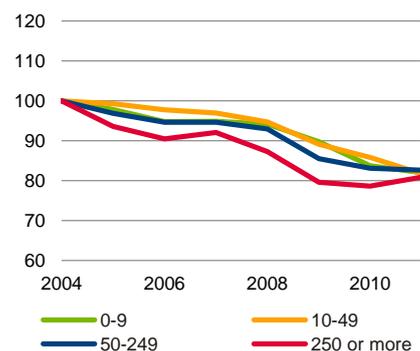
The construction sector made a disproportionately strong contribution to the expansion of the company sector in Portugal up to 2008, too, but the trend was much more moderate than in neighbouring Spain. Nevertheless, the decrease in the number of companies in this specific sector is at least partially the result of a "normal" correction. What is worrying, though, is the fact that since the early 2000s there has been an unbroken decline in the number of manufacturers (chart 8). This continuing de-industrialisation process that has hit companies of all sizes is not attributable to the crisis. It mainly reflects Portugal's low level of industrial competitiveness and the shifting of production capacities during the EU's eastern enlargement phase in 2004.

As in Spain, SMEs and large companies recently have followed diverging trends. While the number of large companies is fairly stable, SMEs have been on a constant, ongoing downtrend. However, unlike Spain, where the number of small and medium-sized enterprises had shown disproportionately strong growth before the crisis, Portugal had previously registered no significant increase except for micro enterprises. The situation is made more difficult by the fact that start-up firms in Portugal had particularly poor chances of survival. Of the companies set up in 2006, only 51% were still operating three years later. The survival rate was considerably higher even in Spain at 58%, and likewise in Italy (61%).⁴

Creeping de-industrialisation in Portugal

8

Manufacturing companies; 2004=100



Source: INE

Italy

In Italy, the companies in the medium-sized segment have unequivocally lost out in the crisis. While the number of micro and large enterprises remained largely stable between 2006 and 2011, firms with 10 to 250 employees have fallen back considerably since 2008 (chart 9). Of all the countries analysed in this study, Italy reports the largest share of employment and value added being generated by micro enterprises. It is especially from this perspective that a shift

⁴ OECD (2013), Entrepreneurship at a Glance.

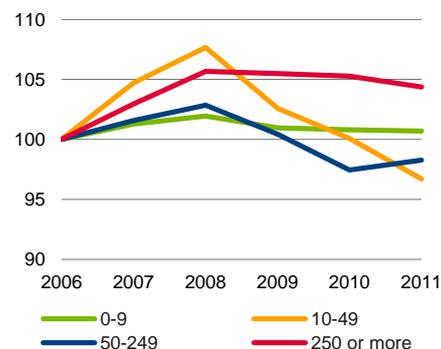


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Italy: Number of enterprises

9

All sectors; 2006=100



Source: ISTAT

in the number of small companies towards more competitive larger SMEs would offer efficiency-boosting potential.

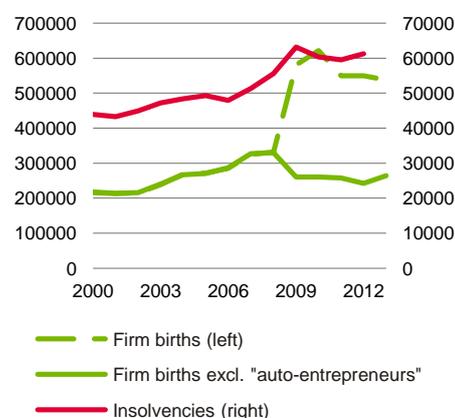
Italy's generally difficult economic situation seems to be weighing disproportionately heavily particularly on those sectors and regions that are actually the pillars of Italian business. Between 2009 and 2012 some 5.2% of manufacturing companies reported insolvency, with the producers of household goods and textiles in fact exceeding 7%. In the services sector, by contrast, only 2.2% of the joint-stock companies filed for insolvency, and in the construction sector 4.6%. During the same period, both insolvencies and voluntary liquidations were up more sharply across the entire spectrum in the economically more important regions to the northeast and northwest than in the centre of the country or to the south.⁵

France

At first glance, France's corporate landscape has also displayed two-pronged dynamics since 2008. While the number of micro enterprises has increased apparently oblivious to the crisis, all the other categories have lost considerable ground. However, this development is based on a structural break. The positive overall trend is distorted by the fact that France has created a new legal structure for the self-employed who employ no other staff. Referred to as "auto-entreprises" they are subject to simplified methods for starting a business and paying social security contributions and income tax. Moreover, they are not subject to value-added tax (VAT). However, "auto-entrepreneurs" are only allowed to earn an annual income of EUR 32,600 (or EUR 81,500 if they are resellers of goods or materials). For this reason, this legal form is mainly an option for part-time workers and is not an alternative for micro enterprises with realistic growth potential. In the statistics, though, they are included with the micro enterprises and are not reported separately. In 2008 alone the establishment of "auto-entrepreneur" status led to an increase of over 300,000 enterprises, meaning that the data for France are not comparable with those of other countries. At least for the manufacturing sector there is evidence of a decline reflecting the continuing process of de-industrialisation. Manufacturing's share in total value added has fallen since 2000 from about 15% then to only about 10% now.⁶

Firm dynamics in France

10



Source: INSEE

The dynamics of the French corporate sector, i.e. the start-ups and insolvencies, is more informative as France's statistical office INSEE provides reports on start-ups excluding the "auto-entrepreneur" category.⁷ As shown in chart 10, start-ups and bankruptcies followed a similar rising trend until 2006. From 2006 the number of insolvencies skyrocketed, peaking at nearly 63,000 in 2009 and holding steady at just minimally below that level since then. A fairly strong cyclical effect has become visible among the start-ups of late: excluding the roughly 300,000 new "auto-entrepreneurs" registered annually the number of start-ups has stayed about 20% below the 2008 level over the past few years. It was not until 2013 that start-ups began to show incipient growth again. The negative trend among regular start-ups to be observed since 2009 can probably not be explained solely by the fact that company founders registered their business as an "auto-entrepreneur" rather than a regular enterprise. An INSEE study found that three out of four auto-entrepreneurs surveyed said they would not have set up any enterprise at all without the new arrangement.⁸

⁵ Cerved Group (2013). Monitor of bankruptcies, insolvency proceedings and business closures.

⁶ Heymann and Vetter (2013). Europe's re-industrialisation: The gulf between aspiration and reality. EU Monitor. Deutsche Bank Research.

⁷ The "auto-entrepreneurs" are not listed in the insolvency statistics anyway.

⁸ Barruel, Darriné, Mariotte and Thomas (2012). Trois auto-entrepreneurs sur quatre n'auraient pas créé d'entreprise sans ce régime. INSEE.

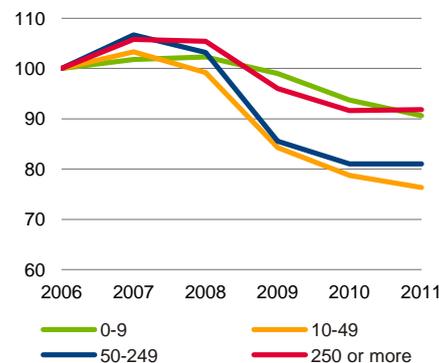


Business demographics and dynamics in Europe

Ireland: Decline across the board

11

All sectors; 2006=100



Source: CSO

Ireland

In Ireland the number of firms from all categories started to plunge as of 2007 (chart 11). Hardest hit here too were the small and medium-sized enterprises whose number currently comes to only about 80% of the 2006 level. Both the biggest and the smallest firms were affected comparatively little. Ireland is also a case where the construction sector had the biggest negative impact, there too due mainly to medium-sized and large companies. The manufacturing slumps were more moderate in contrast.

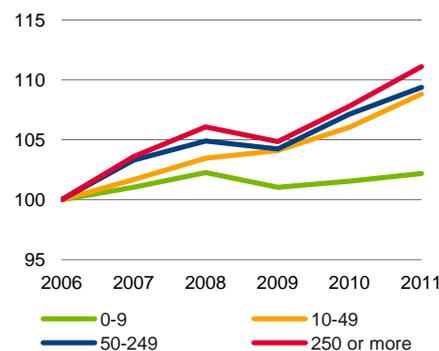
Germany

Tracking the development of GDP, the company trend buckled slightly in Germany in 2008 but soon recovered again afterwards (chart 12). Since 2009 the number of companies has shown positive growth in all size categories. All in all, the number of companies registered in Germany has increased by just a tad; however, this is mainly due to the fact that the number of micro enterprises has remained almost constant. Small, medium-sized and large companies have increased considerably in number despite the crisis in the euro area, which also explains the encouraging performance in the labour market. The most pronounced differences were in the manufacturing sector, where the number of micro enterprises in fact fell, while medium-sized and large industrial companies in particular showed remarkably positive growth. This is attributable to the fact that as businesses increase in size they focus more on exports and have thus been able to benefit more from higher growth outside the eurozone.

Germany: Larger firms are growing

12

All sectors, 2006=100



Source: Destatis

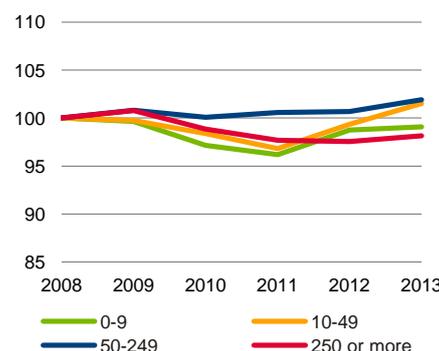
United Kingdom

In the United Kingdom the number of enterprises remained very stable between 2008 and 2013 (chart 13). The moderate slump between 2008 and 2011 has meanwhile been virtually overcome. Unlike in almost all the other countries, the differences between the size categories were generally very small and the evolution quite similar.

UK: Very stable evolution

13

All sectors; 2008=100



Source: ONS

Funding access and conditions

As already mentioned at the outset, large companies generally have efficiency advantages vis-à-vis smaller firms. The possibility of realising economies of scale results in significant cost savings. Moreover, larger companies enjoy diversification benefits, e.g. with regard to their regional sales markets, their products and potential funding channels. This makes a smaller company inherently more vulnerable to risk than a larger competitor. Especially an economically difficult environment marked by numerous company liquidations and little chances of survival for start-ups amplifies these differences even more.

Of particular interest at present are the funding possibilities for small and medium-sized enterprises. Both micro enterprises and large companies operate under different conditions. Owing to their lower investment intensity micro enterprises have less need for capital and rely more on savings. Their demand for sizeable credit volumes in particular is much lower than among larger SMEs. While large multinational companies have greater funding requirements, they are much less reliant on the domestic capital market than SMEs: they have a wider selection of funding sources at their disposal, can enjoy easier and cheaper recourse to capital market funding and/or raise capital abroad.



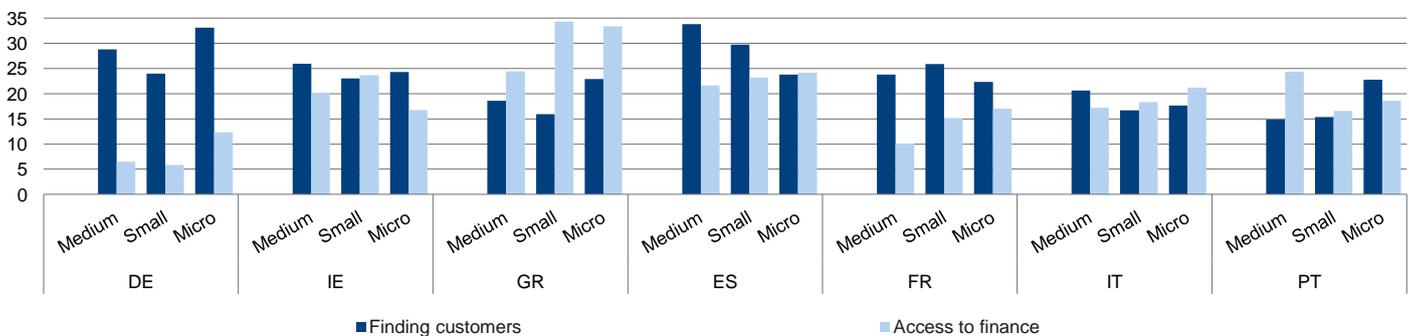
Business demographics and dynamics in Europe

As part of SAFE (Survey on the access to finance of SMEs in the euro area), the ECB gathers data from companies of differing sizes at six-month intervals especially in order to determine their external funding requirements and the related terms and conditions agreed. In response to the question about the most pressing problem currently facing them, the majority of those surveyed in the latest round between April and September 2013 named in most countries the difficulty of winning new customers. In this context, Greece stands out because all across the company size categories the biggest problem identified was access to funding. In the other crisis countries, too, many SMEs cite funding access as a limiting factor. In Italy and Portugal a narrow majority considered this a major problem, while in Ireland and Spain it ranked second behind weak customer demand.

The currently most pressing problem is...

14

Micro: fewer than 10 employees; small: 10-49 employees; medium-sized: 50-250 employees



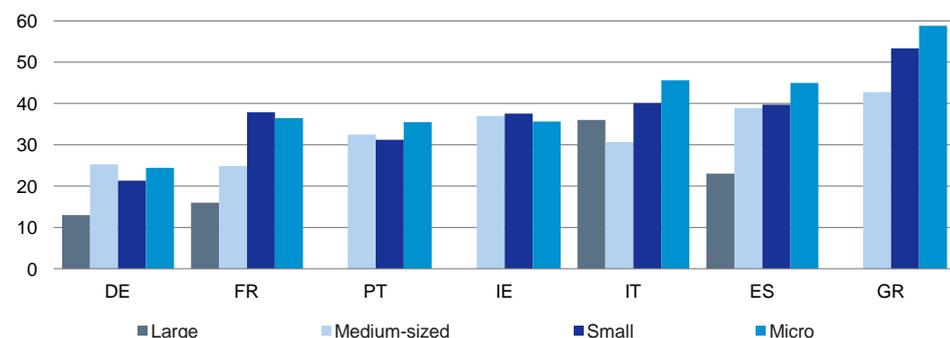
Sources: SAFE, EZB

In order to obtain a more detailed picture of the funding difficulties facing company managers these were asked to state how seriously they rated the problem of access to external funding on a scale of 1 (no problem at all) to 10 (very serious). With regard to the share of companies that stated a value of at least 7, indicating major or very major difficulties obtaining loans, a significant divergence could be seen in some countries in terms of company size (see chart 15). This is prominent in Greece, where funding access is a serious problem for 43% of the medium-sized enterprises, 53% of the small firms and 59% of the micro enterprises. In Spain and Italy, too, there is a pronounced difference in size within the SME category, though not in Ireland, Portugal or Germany. Except in Italy, only a few large companies regarded access to bank funding to be a problem.

Smaller enterprises face greater funding difficulties

15

Percentage of firms stating at least 7 on a scale from 1 (access to finance is no problem at all) to 10 (very pressing problem); SAFE wave released in October 2013



No data available for large companies in PT, IE and GR

Sources: SAFE, Deutsche Bank Research



Business demographics and dynamics in Europe

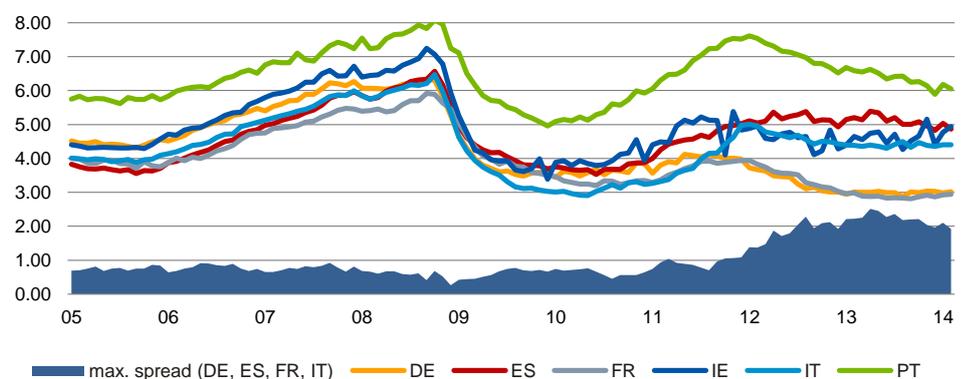
The picture in France is polarised. There, only 16% of the large enterprises and 25% of the medium-sized ones stated that they had serious difficulties in obtaining loans, which roughly matches the German level. By contrast, France's small and medium-sized enterprises are more in the range of Ireland and Portugal at close to 40%.

Concerning the actual use of bank loans over the six months preceding the survey it emerges that large companies are, on average, to be found at the same level as medium-sized enterprises. In comparison, small and micro enterprises took less recourse to bank loans, although this is not solely attributable to potentially more difficult funding access. A substantial share of micro enterprises say that this funding source is currently not of relevance (31%, compared with 22% for small and medium-sized ones, and 19% for large companies). This partly reflects the lower capital requirements of smaller enterprises on account of their lower propensity to invest, but also the fact that internal funding is more important in this segment.

The development of the funding gap according to company type can also be determined on the basis of debt interest rates. The average interest charged for loans of less than EUR 1 m can be taken as a benchmark for SMEs' funding costs. Chart 16 shows that the pre-crisis rates in Spain and Italy were lower than in Germany and that they more or less tracked the pattern in France and Germany up to 2011. Throughout this period, Portugal and Greece always had a spread of 100-200 basis points above the levels in the other countries.⁹

Average interest rate on loans to non-financial corporations of less than EUR 1 m

16



Sources: ECB, Deutsche Bank Research

The shaded blue area illustrates the maximum interest rate spread between the four largest euro members. Up to 2011 the average interest costs in the most expensive of the respective countries were never more than 100 basis points higher than in the cheapest country, but since the end of 2011 a two-pronged development has become evident. While the average rates in Germany and France have declined since then, they have persisted at a high level in Italy and Spain, so the maximum difference between these four countries has permanently exceeded 200 basis points in 2013. Compared with their peak over the past two years (April 2013 in Spain; January 2012 in Italy) the two countries saw the spread narrow by a good 50 basis points by the end of 2013.

⁹ The interest curve for loans of less than EUR 1 m in Greece is similar to the curve in Portugal, but the time series data for Greece are not continuously available and thus not included in the chart.

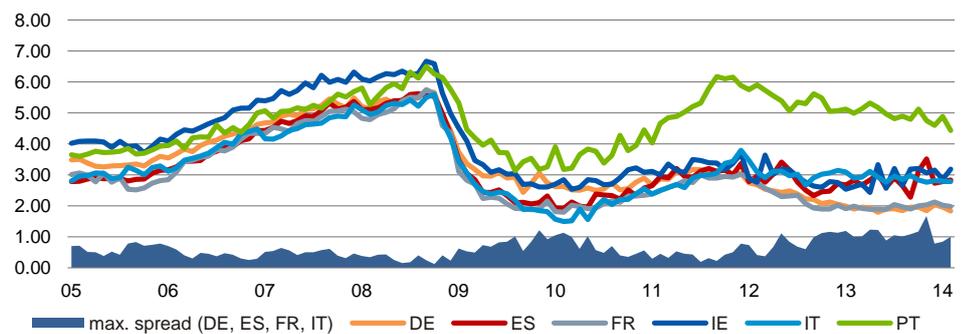


Business demographics and dynamics in Europe

The pattern of interest rates for loans over EUR 1 m is qualitatively similar, but the spread between funding costs was very much less pronounced. Large loans were cheaper in Spain and Italy than in Germany up to 2011. Since then there has been a persistent spread between France and Germany on the one hand and Italy and Spain on the other. At about 100 basis points, however, this is only about half as wide as on loans of less than EUR 1 m.

Average interest rate on loans to non-financial corporations of over EUR 1 m

17



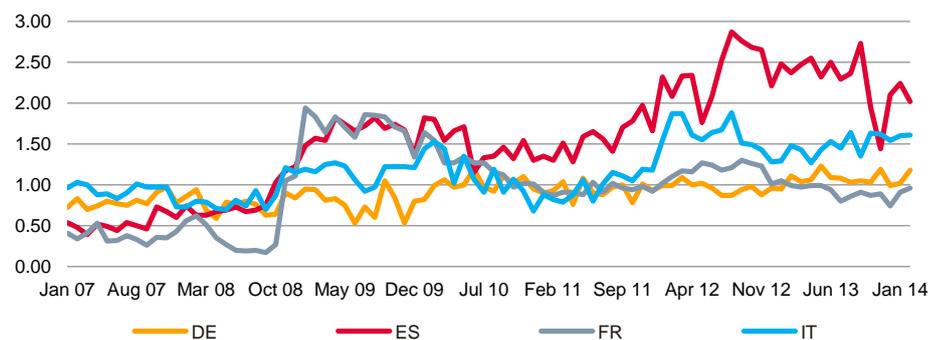
Sources: ECB, Deutsche Bank Research

Chart 18 illustrates this cost spread between large companies and SMEs. Before the crisis the interest spread between small and large loans in the four biggest euro area countries totalled less than 100 basis points. At end-2008, France and Spain experienced a relative deterioration of conditions for loans of less than EUR 1 m. While the picture soon returned to normal in France, the spread in Spain – and in parallel also in Italy – widened once again in 2012.

Spain and Italy: Cost spread between large and small loans widened

18

Interest rate for loans < EUR 1 m minus interest rate for loans > EUR 1 m

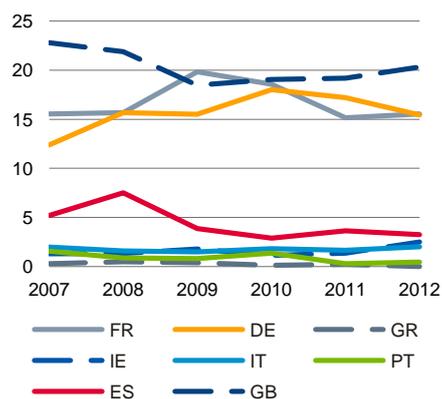


Sources: ECB, Deutsche Bank Research

Venture Capital not flowing to the periphery

19

% of VC investment in the EU



Sources: EVCA, Deutsche Bank Research

A further problem for SMEs on the eurozone periphery apart from difficulties in obtaining bank loans is the still poor availability of alternative funding sources such as private equity and venture capital. Compared to 2007 and 2008 the total volume of venture capital investment in Europe fell by 50% during 2009 and 2012. This is exacerbated by the fact that the southern European countries' already low share in fact continued to shrink. From 2009 to 2012 only slightly less than 8% of European venture capital investments flowed to the GIIPS countries (in 2008 the reading still came to 11.8%) – France and Germany alone each report twice this figure and the share of the United Kingdom is even higher, at about 20%. While Spain was able to attract substantial amounts of venture capital before the crisis, Italy's Europe-wide share has never exceeded 2% since 2007.



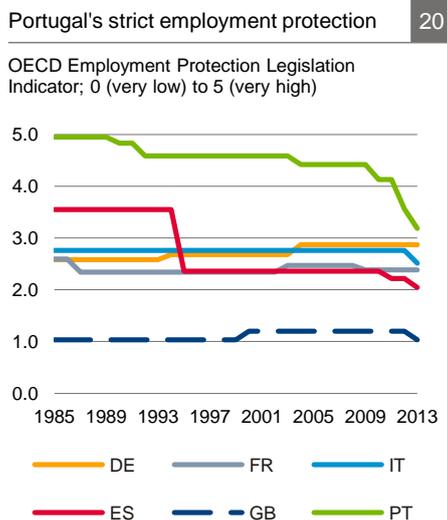
Regulatory obstacles to growth

SMEs' difficult funding access on the periphery of the eurozone is mainly a crisis-specific obstacle and the situation is likely to return to normal as the economy starts to pick up and companies' growth prospects improve substantially. However, many countries also display structurally induced curbs on growth which disadvantage larger SMEs in particular in comparison with small firms and large companies. This may also have an impact on the distribution of enterprises by size.

Each country has some special rules applicable to small firms and micro enterprises aiming to save them unnecessary bureaucracy and costs, which is – in principle – a very sensible idea. However, if these exemptions lose their validity when a threshold size is reached, growing beyond this threshold produces additional costs. As a result, firms only have an incentive to expand across such a threshold if their anticipated growth potential is so high that they can subsequently compensate for the additional costs. France provides a well-documented case in point: a threshold crops up there between 9 and 10 employees, and above all between 49 and 50. Starting from a staff of 10, for example, stricter rules apply to dismissals for business-related reasons, while from 50 staff members an employee representative body must be set up and provided with a budget equal to at least 0.3% of total wages.¹⁰ The simplifications for micro and small enterprises thus make it unattractive to hire 50 or few more employees, which is why there is a sizeable number of firms with 45 to 49 employees. For one thing, those companies with staff exceeding this limit lose the benefits offered by the rules for small businesses and, for another, the higher (fixed) costs cause them more problems than they do large companies for which similar rules apply.

Gourio and Roys (2012) estimate that firms crossing the size threshold incur a one-off (“sunk”) cost approximately equal to an average employee’s annual salary as well as a per-period cost (“payroll tax”) of 0.04% of total wages. Since many SMEs prefer to employ only 48 or 49 persons instead of 50 or 51, potentially available jobs remain vacant, so the aggregate effect is higher unemployment. Garicano et al. (2013) estimate that the macroeconomic costs run to 4-5% of GDP.¹¹ Given the restrictiveness of several of their assumptions this figure appears to be rather high, but it is clear that “arbitrary” regulatory growth thresholds have negative macroeconomic effects.¹² Another consequence, moreover, is inefficient resource allocation, since firms with low growth potential are given preference over more efficient firms.

A very negative effect from regulatory obstacles to growth has also been ascertained for Portugal.¹³ Especially the restrictive labour market institutions and tax disadvantages for larger firms are responsible for a shift to the left in the size distribution of Portuguese firms – in contrast to the trend in other industrial nations – in the past 25 years. During this entire period Portugal was the country with the strictest dismissal protection in the EU (see chart 20). Even in the wake of several structural reforms Portugal still has the highest level in the OECD. This naturally makes companies reluctant to hire new staff since in times of recession it is virtually impossible to reduce the number of employees to match lower demand.



Sources: OECD, Deutsche Bank Research

¹⁰ Guorio and Roys (2012). “Size-dependent regulations, firm size distribution, and reallocation.” NBER Working Paper 18657.

¹¹ Garicano, LeLarge and Van Reenen (2013). “Firm size distortions and the productivity distribution: evidence from France.” NBER Working Paper 18841.

¹² The data for the Guorio and Roys (2012) study cover the period between 1994 and 2000, those for Garicano et al. (2013) between 2002 and 2007.

¹³ Braguinsky, Branstetter and Regateiro (2013). “The incredible shrinking Portuguese firm.” NBER Working Paper 17265.

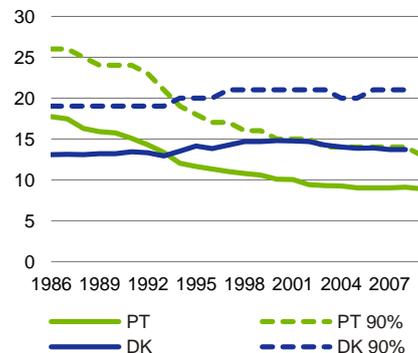


Business demographics and dynamics in Europe

The shrinking Portuguese firm

21

Employees per firm in Portugal and Denmark; average and 90% percentile



Source: Braguinsky et al. (2013)

Chart 21 illustrates that the average headcount in Portuguese firms has fallen from 17.7 since 1986 to about 9 now. In 1986 a firm had to have more than 26 employees to be among the country's top 10% by size; today only half that number is required. By comparison, the average company size in a country like Denmark (and most of the other OECD countries) has slightly increased. True, there were some parallel developments in Portugal which can also partly explain the observed trend, e.g. liberalisation of the economy and the break-up of government monopolies in the early 1980s, or the shift away from uncompetitive manufacturing towards services. However, Braguinsky et al. (2013) show that the structural obstacles are responsible all in all for over 50% of the shrinking effect.

At first glance, Italy is a comparable case as it is similarly marked by a high level of dismissal protection (see chart 20). The threshold there from which the applicable labour law stipulations become much stricter is 15 employees. For the period from 1986 to 1998 Schivardi and Torrini (2009) provide evidence that this threshold had an only slightly negative growth effect.¹⁴ However this could also be attributable to the fact that firms just over the threshold had a higher share of temporary employees in order to avoid the most restrictive dismissal protection clauses. Unlike in Portugal, the high level of dismissal protection in Italy did not lead to an observable decline in company size.

In Germany there are about 160 different legal threshold values altogether, of which roughly 60 are anchored in the law governing labour relations in the workplace (Betriebsverfassungsgesetz).¹⁵ According to Koller et al. (2011), the threshold at which most of the additional regulations kick in is 20 employees.¹⁶ It is particularly because of the multitude of thresholds that no significant negative employment effects of a single threshold could be identified, but all in all they lead to higher costs across the entire firm size distribution. This complexity thwarts the actual intention of reducing the amount of bureaucracy facing SMEs.

In principle, the effect of excessive preferential treatment of small firms leads to the result that the more successful ones among them will rapidly encounter unnecessary obstacles during their expansion. If a cost wedge is driven between firms that are just above and just below a threshold even when they still have a relatively manageable size, the result is a loss of growth incentives and hence lost jobs and efficiency. For this reason it would make sense to set as few thresholds as possible. Those regulations that are already regarded as absolutely essential for small firms should be bundled together at one single threshold. Any stipulations above and beyond these should not kick in as early as the threshold of 50 employees, which is relevant for many SMEs. Instead, they should be set in such a way that they only affect larger companies for which the fixed costs of regulation are not as significant.

¹⁴ Schivardi and Torrini (2008). "Identifying the effects of firing restrictions through size-contingent differences in regulation." *Labour Economics*, 15(3), pp. 482-511.

¹⁵ Koller, Schnabel and Wagner (2007). "Schwellenwerte im Arbeitsrecht: Höhere Transparenz und Effizienz durch Vereinheitlichungen." *Perspektiven der Wirtschaftspolitik*, 8(3), pp. 242-255.

¹⁶ This includes, among other things, the requirement to employ severely disabled persons (or alternatively to pay a duty in lieu of employment), to appoint a safety officer and to expand the works council to three members along with extended co-determination rights. See Koller, Schnabel and Wagner (2011). "Beschäftigungswirkungen arbeits- und sozialrechtlicher Schwellenwerte." *Zeitschrift für ArbeitsmarktForschung*, 44. pp. 173-180.



Conclusion and outlook

Small and medium-sized enterprises were the big losers in the euro crisis countries over the past few years. In Spain, Italy and Ireland their numbers decreased much more sharply than those of large companies or micro enterprises with fewer than 10 employees. In countries that suffered shorter slumps in the real economy (e.g. Germany and the United Kingdom), such shifts within the size categories were not to be observed. However, Italy, Portugal and Spain in particular are still marked by a very fragmented corporate structure with a large share of micro enterprises. It is precisely here that boosting the competitiveness of medium-sized enterprises would have positive effects on productivity and employment.

Independently of the current situation, efforts should be made in the medium term to reduce the dependence of small and medium-sized enterprises on the growth of the domestic economy. Supporting the diversification of sales and funding channels is needed just as much as eliminating unnecessary regulatory obstacles. In a corporate environment dominated by SMEs it is not possible to achieve the employment boost urgently required in the southern European countries without sustained growth in the small and medium-sized business segments.

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