National Competitiveness and Productivity Council
Bulletin 21-5 Firm Dynamism and Productivity

NCPC National Competitiveness & Productivity Council An Chomhairle Náisiúnta Iomaíochais agus Táirgiúlachta

- **A functioning business environment, where labour and capital resources are efficiently reallocated to the most productive activities, is crucial for long-run aggregate productivity growth**
- **The COVID-19 pandemic has impacted every aspect of the economy, including the birth, survival and death rates of enterprises, which will have implications for the future competitiveness of the Irish economy**
- **Appropriate policies are required to support enterprises through the whole life cycle, from start-up, through the growth phase, to closure**
- **Further research and analysis is needed in Ireland to better understand the underlying determinants of enterprises' entry and exit decisions and support enterprise churn rates to boost productivity growth**

THE NATIONAL COMPETITIVENESS AND PRODUCTIVITY COUNCIL

The National Competitiveness and Productivity Council's (NCPC) mission is to promote sustainable economic growth and quality employment so that living standards and quality of life improve for all of society. To achieve sustainable economic growth, a wide range of factors needs to be considered, including improvements to Ireland's business environment and physical infrastructure, as well as the efficient utilisation of knowledge and talent.

THE IMPORTANCE OF FIRM DYNAMICS

Firm dynamism refers to the process of firm entry, growth, and exit. New and young firms are key to boosting aggregate productivity growth through job creation and the introduction of new business models and innovations[1]. For competition to be effective there must also be exit by unprofitable firms, which is key to renewing the industry population through a process of "creative destruction"[2]. Without market exit, less efficient firms trap resources (both financial and human capital) when they should be reallocated to more efficient use. The close link between firm dynamics and human capital means the impact on employees is also an important consideration.

Recent patterns observed across advanced economies indicate a decline in business dynamism, undermining the process of productivity-enhancing reallocation. Specifically, recent studies have highlighted a decline in entry rates while exit rates remain stable. A low start up rate coupled with a stable exit rate could hold back productivity growth due to new entrants with modern business processes being fewer in number, while entrepreneurs and employees are trapped in lower-productivity employment. For example, an OECD study, in 2020, found that the decline in business dynamism in many countries was evident even after accounting for the role of the business cycle, and that entry rates and job reallocation rates experienced an average decline of about 3-5 percentage points between 2000 and 2015[3].

Market power, reflected in high levels of industry concentration, is a key factor related to declining business dynamism. High levels of concentration can discourage innovation and evidence suggests that it has contributed to a slowdown in global productivity growth[4]. Furthermore, high market power may reduce the chances of firms overtaking the current market leaders, potentially reducing incentives for experimentation and innovation.

Studies in the United States[5] have found that the entry rate of new businesses, the job reallocation rate, and the labour share of output have all been decreasing. At the same time, the profit share, market concentration, and mark-ups have all been rising. The analysis suggests that IT innovations may have facilitated the rise in concentration and the growth in the profit share. The assets required to innovate (such as the inputs and outputs of innovative activity, trademarks, software and databases) allow for economies of scale that may strengthen the advantage of established firms, reinforce the position of leaders, and reduce entry and reallocation.

FIRM DYNAMICS IN IRELAND

Following the onset of the Global Financial Crisis, the enterprise birth rate[6] slowed in Ireland, and globally, due

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[1] Romer (1986) Increasing Returns and Long-Run Growth

[2] Schumpeter (1942) Capitalism, Socialism, and Democracy. Harper & Brothers, New York

[3] OECD (2020) Declining business dynamism: Structural and policy determinants

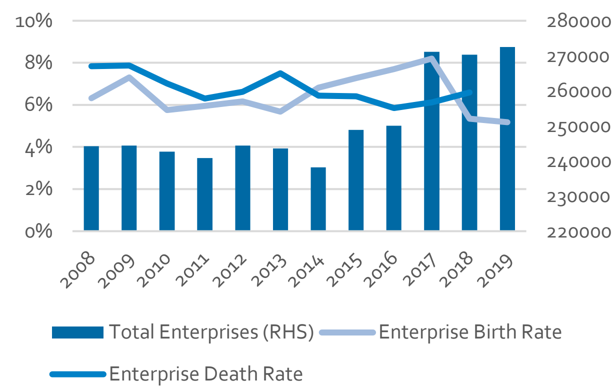
[4] Federal Reserve Bank of San Francisco (2019) Is Rising Concentration Hampering Productivity Growth?

[5] Akcigit & Ates (2019) "What Happened to U.S. Business Dynamism?,"

[6] The enterprise birth rate is calculated as the number of enterprise births in the reference period (t) divided by the number of enterprises active in period (t).

to the debt overhang and higher cost of credit, as well as more precautionary behaviour of entrepreneurs and investors (see Figure 1). In Ireland, the enterprise death rate[7] remained above the enterprise birth rate throughout the crisis period and the total number of active enterprises stagnated. The number of enterprise deaths was relatively high at the onset of the financial crisis, but also spiked once again in 2013 as accumulated vulnerabilities took their toll on enterprises. As macroeconomic conditions improved, the number of enterprise births began to gather pace, while the number of enterprise deaths reached a series low in 2016.

Figure 1: Irish Business Demography Statistics



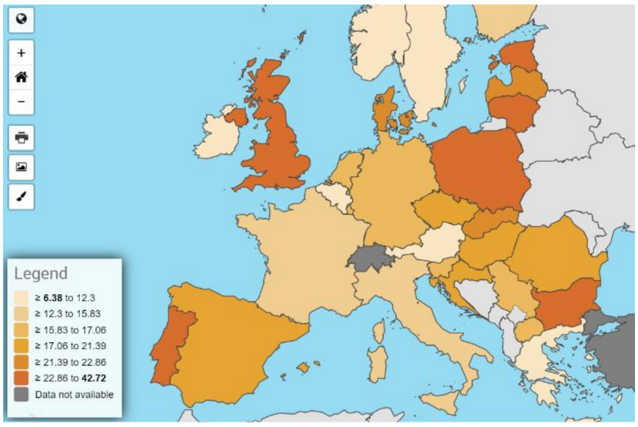
Source: Central Statistics Office

The enterprise birth rate in Ireland has generally been significantly lower than the rate observed in other European countries. In 2018, Ireland's enterprise birth rate of 5.3% was almost half of the European average of 10.3% and significantly below the European leaders: Lithuania (19.0%), Portugal (16.0%), Malta (14.9%) and the UK (13.5%)[8].

The enterprise death rate in Ireland has also historically been lower than in our European counterparts. In 2018, Ireland's enterprise death rate of 6.6% was 2 percentage points below the European average of 8.5% and considerably lower than the corresponding rates observed in Bulgaria (26.0%), Lithuania (23.7%), Portugal (12.8%), and the UK (11.3%).

The enterprise churn rate is defined as the sum of enterprise birth and death rates and is a commonly used proxy for entrepreneurial dynamics. A low enterprise churn rate can adversely affect productivity growth, given a more limited resource reallocation from less productive firms to young SMEs. Start-ups and young firms, often a source of radical and disruptive innovations, are important drivers of growth due to their disproportionate contribution to aggregate job creation and the productivity-enhancing effect associated with a higher pace of firm entry and exit[9]. Figure 2 below shows that Ireland's enterprise churn rate in 2018 was relatively low when compared to our European neighbours.

Figure 2: Business Churn Rate, 2018



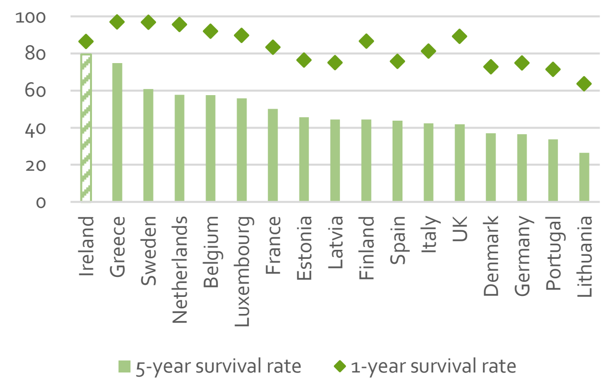
Source: Business Demography Statistics, Eurostat

Another useful metric when examining firm dynamics is the enterprise survival rate[10]. Many newly created enterprises fail within their first few years, with important differences noted across countries[11]. Using the OECD Structural and Demographic Business Statistics Database, the one-year survival rate for OECD countries averaged roughly 80% in 2018. The enterprise survival rate fell to approximately 60% after 3 years from entry and declined further to just below 50% after 5 years. In the majority of OECD countries sampled, the probability of exiting is highest when businesses are two years old.

In Ireland, the one-year enterprise survival rate was 86.4% in 2018, a marginal decline from a rate of 86.7% recorded the year before, and slightly above the OECD average (see Figure 3). In 2017[12], the 5-year enterprise survival rate was 79.5% in Ireland, the highest value reported in any OECD country and significantly above the average rates seen in other countries, where typically only half of firms survive after five years. Further research and analysis is needed to better understand the higher survival rates amongst Irish enterprises and to identify the firm or sector specific factors that contribute to these higher rates.

[7] The enterprise death rate is calculated as the number of enterprise deaths in the reference period (t) divided by the number of enterprises active in period (t).
[8] Business Demography Statistics, Eurostat.
[9] OECD (2017) Entrepreneurship at a Glance 2017
[10] The enterprise survival rate is calculated as the number of enterprises in the reference period (t) newly born in t-n having survived to t, divided by the number of enterprise births in t-n.
[11] OECD (2017) Entrepreneurship at a Glance 2017
[12] 2018 data for Ireland's 5-year survival rate is not yet available in the OECD Database.

Figure 3: Survival Rates, Select OECD Countries, 2018



Note: Data for EL is the 3-year survival rate. Data for IE refers to 2017.

Source: OECD SDBS Database

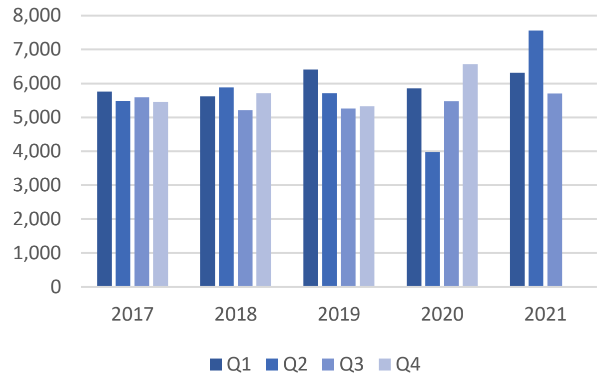
THE COVID-19 PANDEMIC

The COVID-19 pandemic has impacted every aspect of our society and our economy, including the creation of new enterprises and the cessation of activities in enterprises that no longer have a market for their goods or services. Due to the time lag associated with the publication of the CSO and Eurostat Business Demography Statistics, this section uses data from the Company Registrations Office (CRO) to examine more recent trends in enterprise registrations, insolvencies and dissolutions. This dataset is not directly comparable to the Business Demography Statistics described earlier due to the different compilation methodologies involved.

The number of new company registrations declined by 30.4% in the second quarter of 2020 compared to the same period of 2019, as COVID-19 related restrictions curbed economic activity (see Figure 4). However, new registrations recovered swiftly in the second half of 2020 and continued to perform well in the first three quarters of 2021 as entrepreneurs identified new opportunities. The recovery in new registrations was broad based across both regions and sectors.

According to analysis by Crif Vision-net[13], the first nine months of 2021 have seen a 28% increase in new company start-ups across Ireland versus the same period last year. Amongst the top performing sectors in Q3 were leasing (+60%), utilities (+33%), manufacturing (+31%) and finance (+31%). Other sectors to see double-digit growth include wholesale and retail (+18%), transport and storage (+17%) and real estate (+16%). Amongst some of the sectors most impacted by COVID-19, construction saw a modest 4% increase in start-ups. Meanwhile the hotel and restaurant sector experienced a 4% decrease in start-ups.

Figure 4: New Company Registrations



Source: Company Registrations Office

The onset of the COVID-19 pandemic resulted in an unprecedented shock to the Irish, and global, economy. Social distancing requirements have limited many businesses' abilities to service customers and rolling closures through various stages of the pandemic have placed severe strain on the financial wellbeing of many enterprises. A company coming to the end of its lifecycle can be dissolved and removed from the Companies Register either through solvent or insolvent liquidation, or through voluntary or involuntary strike-off. We now turn to look at one aspect of these dissolutions.

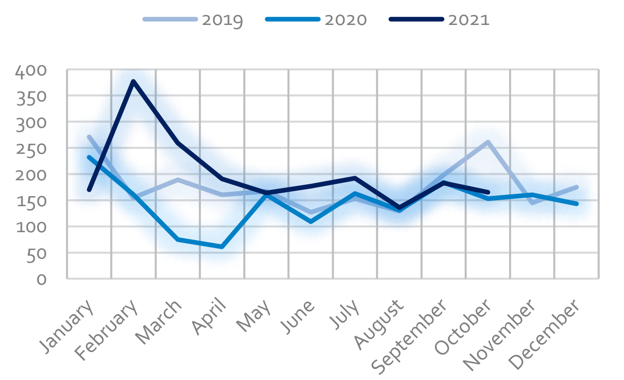
INSOLVENT LIQUIDATIONS

Despite the COVID-19 related pressures on enterprises, the number of insolvent liquidations in 2020 remained lower than in 2019 (see Figure 5). Early in the pandemic, the insolvent liquidation rate unexpectedly fell due to the temporary inability of company directors to convene creditors' meetings safely. Insolvent liquidations returned to pre-pandemic trends in the second half of last year. A temporary increase in insolvencies was recorded in the early months of 2021 but levels are now broadly in line with levels recorded in 2019 and 2020, despite the difficult economic circumstances. The cumulative effect of government wage supports, deferred tax liabilities, loan payment breaks, forbearance from other creditors, highly accommodative monetary policy and pre-existing financial buffers are all likely to be contributing to holding down the insolvent liquidation rate[14].

[13] VisionNet (2021) Business Barometer - Irish and UK Company Information - Vision-Net

[14] McGeever, Sarchi and Woods (2020) Irish company births and insolvent liquidations during the COVID-19 shock (centralbank.ie)

Figure 5: Notice of Appointment of Liquidator



Source: Company Registrations Office

An April 2021 research paper by the Central Bank of Ireland and the ESRI found that almost a quarter of SMEs could be vulnerable to liquidation as the pandemic evolves and insolvency criteria normalises[15]. In September 2021, the Department of Finance published the SME Credit Demand Survey[16] which showed that SME credit demand from banks was lower in March 2021 than March 2019[17], with 20% having applied for bank finance in the March 2021 period compared to 25% in March 2019. Compared to the October 2020 period, credit demand increased from 18% to 20%. Positively, the main stated reason for not seeking credit was sufficient internal funds, which was cited by 72% of businesses not seeking credit. However, the survey also reported that 19% of SMEs reported that they had missed repayments of some type in March 2021, compared to just 5% in March 2019, which may indicate growing financial strains.

While insolvency rates to date remain in line with pre-pandemic trends, as more of the economy opens up and financial supports are gradually withdrawn, this could result in an increase in the number of firms facing financial pressure. Previous analysis by the World Bank[18] indicates that it took 13 quarters from the onset of the global financial crisis in 2007 before there was a corresponding spike in non-performing loans, while in Ireland, non-performing loan ratios continued to rise until late 2013 when they peaked at 32%[19]. This suggests higher insolvency rates could persist for some time due to the complexity and time lag associated with recessionary events. There is also likely to be an increase in the level of voluntary strike-offs and other forms of dissolution, as enterprises that are unable to viably trade choose to wind up operations.

POLICY IMPLICATIONS

The uncertainty surrounding the level and timing of insolvent liquidations raises a difficult trade-off for policy makers. As previously addressed in *Ireland's Competitiveness Challenge 2021*[20], if the scope and size of business supports currently in place is a primary factor explaining low levels of insolvency, any extension of these schemes could result in unviable firms surviving for longer and dampening productivity in the wider economy. However, on the other hand, the removal of these supports too quickly, before the recovery is embedded, runs the risk that those firms that are viable, but vulnerable will face a sudden stop in essential liquidity support that could result in an increase in unnecessary insolvencies. The eventual tapering and final withdrawal of such supports must be carefully balanced to meet the enterprise sector's requirements for recovery, while being cognisant of the limited resources of the State and the need to efficiently allocate them.

As this process evolves for withdrawing support schemes, it is equally important that we have the appropriate insolvency framework in place in Ireland to help businesses restructure. Functioning and efficient resolution mechanisms are vital to business dynamism, as efficient judicial and bankruptcy systems are associated with lower declines in entry rates[21]. Reducing the time and cost of insolvency proceedings can increase the recovery rate and benefit creditors. This can facilitate credit supply and contribute to reducing uncertainty. Furthermore, possibilities for restructuring viable businesses and having efficient closure of failed businesses may contribute to a timely reallocation of resources across firms.

Ireland's existing rescue framework, examinership, is internationally recognised and successful in its own right. However, the commercial reality of the costs associated with it means this important tool is often too expensive for small companies to access. The Council has welcomed[22] the recently introduced Small Company Administrative Rescue Process (SCARP) which aims to simplify the restructuring process for viable small companies in a way that is timely and cost effective. The process provides a

[15] New survey evidence on COVID-19 and Irish SMEs: Measuring the impact and policy response | ESRI
[16] SME Credit Demand Survey - October 2020 - March 2021
[17] Due to Covid 19 restrictions, no interviewing was possible over the same period in 2020 and thus the report for this period was not fielded.
[18] World Bank Paper (2021) The Calm Before the Storm
[19] Quarterly Bulletin QB2 April 2018 (centralbank.ie)
[20] NCPC (2021) Ireland's Competitiveness Challenge 2021
[21] OECD (2020) OECD iLibrary | Declining business dynamism: Structural and policy determinants (oecd-ilibrary.org)
[22] NCPC (2021) Ireland's Competitiveness Challenge 2021

low-cost alternative to examinership for SME's as it is designed to significantly reduce the requirement for court intervention which can be costly.

As the economy and society continue to open, another key policy focus will be on those workers in vulnerable sectors and enterprises that may not recover and who will need to be supported to upskill and retrain for employment in other high-growth sectors. As part of the *Economic Recovery Plan*[23], the new *Pathways to Work 2021-2025* has a key objective of helping those people whose jobs have been permanently lost as a result of COVID-19. It is focusing on preventing long-term unemployment and assisting younger workers who have lost jobs to re-join the workforce through the introduction of a new paid work placement experience programme, an increase in the number of apprenticeships and further education training places available, and improved access to further education and self-employment opportunities.

OECD research analysing business dynamics during the COVID-19 pandemic[24], published in February 2021, highlighted the need for policymakers to complement emergency measures with interventions that address longer-term challenges that existed before the pandemic such as the decline in business dynamism, sluggish productivity growth and increasing polarisation and inequalities. In order to boost the speed and inclusiveness of the recovery, the OECD recommended four key policy interventions designed to:

- boost technology diffusion for an inclusive digital transformation,
- provide the right environment and incentives for start-ups to innovate and grow, and for potential entrepreneurs to enter the market,
- ensure business-friendly framework conditions, to foster experimentation and resource reallocation,
- support transitions into new jobs, especially for more disadvantaged groups of workers.

These policy actions together may bring double dividends for policy makers and strengthen the speed and inclusiveness of the post-COVID-19 recovery.

In the Irish context, further research and analysis is needed to more fully understand the underlying determinants of entry and exit decisions by enterprises, and to identify what firm or sector specific factors may be contributing to Ireland's higher enterprise survival rates. This evidence is needed in order to identify the appropriate policy interventions that will support higher entry, exit and churn rates, and positively contribute to Ireland's productivity growth, by facilitating resource reallocation from less productive firms to young high-growth enterprises.

Further Reading: The Council's annual flagship publication, *Ireland's Competitiveness Challenge 2021*, was published in September 2021 and made 20 targeted and actionable recommendations to Government on how best to address the challenges facing the Irish economy. The Government is due to publish an official response to the Council's recommendations in the coming weeks, signalling its commitment to continued dialogue with the NCPC on competitiveness and productivity matters. The *Challenge* report and previous Government response are available at:
www.competitiveness.ie.

This Bulletin has been issued by the Chair, Dr Frances Ruane, and was prepared by Patrick Condon and Linda Kane in the NCPC Secretariat.

[23] Economic Recovery Plan (www.gov.ie)
[24] OECD (2021) Business dynamism during the COVID-19 pandemic: Which policies for an inclusive recovery?