

ISAE REPORT

*setting national priorities:
firm size, competitiveness,
regulation*

Synthesis

JUNE 2003

CREDITS

The Report is part of a three-year project carried out by ISAE on the causes and consequences of the small size of Italian firms. Thus, it is the result of a team work of a wide group of researchers co-ordinated in this occasion by Efisio Espa. In particular, the drawing up of single Chapters was edited by Efisio Espa and Marco Ventura (Chapter 1); Daniela Marchesi, with the collaboration of Marco Felici (Chapter 2); Luisa Sciandra (Chapter 3); Roberto Basile, Sergio de Nardis, Massimo Mancini, Carmine Pappalardo and Gianni Principe, with the assistance of Emma De Angelis (Chapter 4); Antonella Caiumi (Chapter 5); Stefano Costa (Chapter 6); Bernardo Argiolas (Chapter 7).

The editing was ensured by Beatrice Mariani, the composition was edited by the ISAE Unit "General Technical Services", co-ordinated by Silvia Fanfoni. The English version was translated by Paola Felli and edited by Efisio Espa himself. .

The Report is based on the information and data available up to June 18, 2003.

Summary and Introduction

This is the fourth ISAE Quarterly Report which ISAE devotes to national priorities, that is to topics playing a particular role in the economic evolution of Italy and on which policy-makers have to intervene.

In the past Reports, attention was focused, among other things, on relevant matters such as legislation rigidities, the degree of effectiveness of civil law, public employment, trade liberalisation, obstacles to a larger flows of foreign direct investments. Those matters – each of which points to a (much felt) legislation delay - were analysed partially through instruments typical of the “economic analysis of law”, which is gaining ground in Italy, and partially through the viewpoint of a wider public policy evaluation, which is based on the (non exclusive) idea that economic policy consists of a whole series of rules which economists should examine with much more attention than the one paid so far.

The present Report marks a change in the ISAE approach to national priorities. The formula of analysing four or five different topics having something in common was replaced by the thorough (medium-term) examination of one relevant topic, around which sector analyses are carried out so as to catch the peculiarities and specific features of that particular subject. This approach assumes as pre-requisite that the topic be particularly relevant, complex and persistent to such an extent that the analysis and the medium-term attention are both justified.

The topic chosen for the 2003 Report “Setting national priorities” – which is a part of a three-year project – is the “size question” of the Italian manufacturing system, which draws inspiration from an excellent and thorough book edited in 1999 by Fabrizio Traù, to which we shall often make reference.

The choice to tackle the problem of the small average dimension of the Italian economic system, in general, and of the manufacturing system, in particular, seems justified. Apart from the appeals to the risks that an excessively “pulverised” manufacturing system implies (see the recent interventions of the Governor of the Bank of Italy and of the President of the Antitrust Authority), the size question seems so deeply connected with the dynamics of the Italian manufacturing system, that examining the whole system from this point of view seems to be the best way to assess the quality of so many aspects of legislation and public policies in this area.

The list of factors somehow affected by the size problem is very long: rules and regulations on risk management and financial crises, firm governance, labour market rigidity, capital gains

taxation, financial constraints for small and medium-sized enterprises (SMEs), insufficient infrastructures (all subjects analysed in the present Report), propriety assets, incentive policies, strategies for the emergence of the underground economy, administrative procedures for plant enlargement, the “reply” of firm groups and, in particular, of districts to the size problem, the overall General Government effectiveness, industrial policies, specific obstacles to the internationalisation, the effects of delocalisation, possible impact on firms’ dimensions of the enlargement of the European Union to 25 Member States, and the list might be longer.

Admittedly, the long list of subjects mostly concerns sectors where there seem to be constraints and obstacles to firm growth. Indeed, there are also factors of “opportunity” (think to the incentive policies for SMEs), whereby it is more convenient for entrepreneurs to maintain small dimensions. That bias for small dimensions is a complex matter of investigation, and the risk to make generic statements and provide banal solutions is indeed very high.

The factors hampering firm growth have the advantage of being similar to the model presented in the second Chapter of the Report, where the decision to increase the number of employees (hence capital) is a choice associated to the “normal” firm risk assessment. In particular, those factors seem to contribute to the perception of a higher risk, hence they seem to discourage the entrepreneurs’ decisions to enlarge their firm size. The weight of that risk is even heavier if there are elements favouring the maintenance of small dimension.

The anomaly of the small dimensions of the Italian manufacturing firms has been recognised for a long time. The Italian industrial system – ever since its origin before the unification of Italy – concentrated in the Northern part of the country, is particularly “pulverised”: historian Giuseppe Conti describes it as a “Lilliputian economy”. Thus, in comparison with its European partners, the Italian manufacturing system shows a limited average size in its productive units. For the time being – data refer to the year 2000 – the number of employees per firm equals 8, that is why Italy ranks at the bottom of European countries, where the average size is around 20 employees.

That result gathers two specific and different anomalies which are somehow connected, namely

- a very high percentage of very small firms;*
- the weakness of large (private or public) industrial concerns, which have been showing a profile decreasing through time.*

Identifying an anomaly – which the former President of CONSOB, Luigi Spaventa, during a debate at ISAE defined “the real Italian anomaly” - does not automatically mean evaluating, namely making a qualitative assessment of the dimensions of the Italian manufacturing system. Admittedly,

we are all aware of the contribution given by the Italian SMEs to the Italian economic development. Exports – not only in the “niche” sectors - have been growing for years at a very high pace; the geographical diffusion of development – even in the Mezzogiorno of Italy – has been favoured by the “contagious” model of small firms and districts; the organisational flexibility and the entrepreneurs’ readiness have enabled Italian firms to penetrate new sectors. Then there is the SMEs’ ability to innovate the quality of products (by offering highly specialised and highly-manufactured products) and their marketing strategies; the thrust (running counter to what most people think) to enlarge the firm dimensions; the emergence of competitive and innovative medium-sized firms (described by Valeriano Balloni); the organisation of firms in groups, networks and districts. All those factors have regularly disclaimed the usual complaint about the structural weakness of the Italian manufacturing system. There is no better economic literature than the one inaugurated 30 years ago by Giacomo Becattini and Sebastiano Brusco to understand why a model mainly based on SMEs has been spreading and survived in Italy for so long.

And yet, international changes (the elimination of trade barriers, the entrance on the commodity market of low value-added and low labour-cost products) and domestic changes (the gradual disappearance of a system of large industrial concerns) shed new light on the size question.

The reasons for the scepticism on the strength of the manufacturing system have not changed through time: the reduced economies of scale, the limited expenses in R&D (both in the public and in the private sectors), the little technological innovation, the impossibility to play a role in the great aggregation process at international level, the scarce attractiveness of small firms for foreign direct investments. These are all problems and features which seem to give Italy a marginal role in the European landscape, the role of a country with low productivity, a negative demographic growth and a limited development.

Indeed, though one should not underestimate the capacity of SMEs – starting from those “small multi-nationals” which owns most of the “soft” manufacturing system – to reply to the listed concerns, the problem of the Italian competitiveness is particularly urging in this period. The most important elements seem to be three, namely

- the “suffering” of the Italian productive model - further pressed by the emergence of low-cost productive systems and by their ability to conquer both the “upstream” consumption and the investment goods necessary to traditional sectors (China being the most famous case) - which is clearly shown by the ever growing trend to delocalisation and, in particular, by the considerable losses of market shares registered in the past few years;*

- *the substantial loss on the part of larger firms of their significant presence in Italy in those capital-intensive sectors where economies of scale and productivity gains are more “natural” (in particular, the steel industry, the chemical sector and major sectors of mechanics),*
- *the scarce role of Italy in high value-added and high R&D sectors.*

In this context, on the basis of the statements made so far, it is difficult not to stress our concerns for the future of the Italian industrial system. Indeed, the way in which the problem of the small dimension and the scarce productivity dynamics is forgotten, shows that in fundamental markets (such as the chemical sector) and in most innovative sectors (bio-technologies, technologies based on hydrogen, for example) Italy will play a minor role.

If, on the one hand, thinking to the Italian model of productive specialisation raises complex, even though inevitable, questions (is it necessary to ensure the presence of Italy on almost abandoned markets? Or is it better to enter more innovative markets? If so, in which way? By using public or private capitals? By re-proposing “Beneduce” models like those adopted in the Twenties or “Sinigaglia” models similar to those of the Fifties?), on the other hand, the debate among policy-makers centres on the size problem and on the need for dimensions able to bring about productivity gains.

In its attempt to better understand the room policy-makers have at their disposal to create a less hostile environment for firm growth, this Report analyses a series of sectors in the search for “threshold effects”, of constraints, of obstacles of various nature which policy-making might eliminate.

*Analyses and observations of this kind are carried out in the awareness that SMEs are deeply rooted in the Italian manufacturing system. Thanks to a first-brand industrial historiography, **Chapter 1** synthetically surveys the long-term factors determining small firm dimensions. Localism and closed markets, a birth as small firms of peasant or artisan origin, the weight of regulations different from the present ones, though not less harsh, their roles as late-comers in the industrialisation process of the country are all reasons which help explain the rapid consolidation of a manufacturing structure based on the so-called “soft” sectors and on small productive units. On the top of it, there is a favourable social bias towards a less dangerous array in terms of social – and even households’ - equilibria compared to the one created by large industrial concerns.*

***Chapter 2** is devoted to the bankruptcy law. Admittedly, the need to reform the bankruptcy law has been spreading for years and Parliament was about to examine more than one draft reform, even though this has not happened so far. However, in the late-2001, the Ministry for Justice has set up*

a new Committee chaired by Trevisanato, Attorney at Law, with the task of drawing up a draft Proxy Law on the bankruptcy law reform, which is to be submitted by the end of July. The Chapter draws an international comparison between the 15 EU Member States and the United States to show that the Italian laws on bankruptcy and on risk management and financial crises – which has been enforced since 1942 – may disincentive firms from growing in size. Indeed, the enforced legislation does affect some fundamental variables determining the firms' investment choices (hence their opportunities to grow). In particular, the existing rules seem to affect, on the one side, bank credit costs (and availability) and, on the other side, the cost of investment project failures (i.e. risk gains). Chapter 2 suggests specific policy-making proposals to correct and eliminate those obstacles.

Chapter 3 *examines the reform of the legislation on limited companies. This reform – the enforcement of which shall start in the early-2004 – is bound to exert a significant impact not only on the present situation (Table 1), but also on future economic targets, particularly on entrepreneurial projects to shift to more developed types of companies which are able to favour the access to external financial sources and stimulate firm growth. Indeed, for the time being, administrative and legal complications are an evident constraint to the growth of SMEs (Table 2) and, in this context, they discourage the transformation of firms from a “closed” formula (limited company) to an “open” one (in particular from a private to a public limited company).*

Given the wide scope of the new legislation (modifying the whole section of the civil code devoted to limited companies), the analyses contained in the Chapter limit themselves to examining the potential impact on firm growth of Legislative Degree no. 6/2003 reviewing the discipline in this area. Within this framework, the analysis is limited to two main questions connected with the re-definition of the legislation on private limited companies and on public limited companies.

TABLE 1

FIRMS BROKEN DOWN BY LEGAL FORM AND NUMBER OF EMPLOYEES

Legal forms	Number of employees					Total
	1-9	10-19	20-99	100-499	500 and beyond	
Sole traders	2,335,917	18,603	3,287	27	1	2,357,835
Partnerships	657,176	44,154	10,328	146	4	711,808
Limited companies	308,789	46,944	41,111	6,242	893	403,979
Co-operative companies	26,062	4,777	4,369	681	94	35,983
Consortia	7,926	277	227	59	15	8,504
Other types of companies	2,550	250	306	147	26	3,307
Total	3,338,420	115,005	59,628	7,302	1,061	3,521,416
			Limited companies in details			
Public limited companies	13,070	4,134	12,438	4,556	800	34,998
Private limited companies	295,545	42,799	28,665	1,683	93	368,785
Other types of limited companies	174	11	8	3	0	196
Total	308,789	46,944	41,111	6,242	893	403,979

Source: ISTAT (1996).

TABLE 2

RIGIDITY INDICATORS OF LEGISLATION BY COUNTRY AND LEGAL FORM

Countries	Public limited companies	Private limited companies	Partnerships	Sole traders
France	2.00	2.37	2.81	1.95
Germany	1.98	2.40	1.48	1.95
Ireland	-	0.32	0.36	0.07
Italy	3.19	2.20	1.85	2.86
Netherlands	1.91	1.54	0.25	0.84
United Kingdom	1.18	0.23	0.12	0.42
Spain	2.39	1.27	0.81	0.69

Source: ISAE (2000).

Chapter 4 tackles the delicate and “difficult” question of the effects of the legislation on firm growth. In particular, on the basis of a three-module investigation, the Chapter examines - also from a methodological point of view- the existence and impact of some threshold-effects (first of all, the limit of 15 employees per firm above which the protection offered by art. 18 of the Italian Workers’ Statute is applied). In detail, both in terms of legal analysis (mainly based on the existing bargaining agreements) and of empirical test, the Chapter identifies a threshold beyond which firm expansion stops. Apparently, the discouraging effect – even though it is statistically visible – is not such that it affects the firms’ choices. However, policy interventions aimed at reducing the disincentive effects – which are adopted – might contribute to foster firm growth.

Also **Chapter 5** faces a complex and delicate subject, namely firm taxation. The lack of a considerable “threshold-effects” in taxation is confirmed by the thorough examination of the existing rules and regulations carried out in the Chapter. Only legislation on direct income

taxation – and to a limited extent which is however not easy to test empirically –, which is characterised by a progressive structure of levies, does affect the evaluations of self-employed subject to the legislation on direct income taxation. Thus, if the existing rules do not disincentive firms wishing to grow, it remains to explain why entrepreneurs have a negative perception of the impact of taxation. A first reason is simply linked to the fact that the entrepreneur's perception of high taxation seems to have a negative effect on the possible expansion of the turnover, of the number of employees and of the taxable income. Another possible explanation – which has often been mentioned in the present Report – concerns that higher degree of transparency (implying additional costs of “emergence”) which, in a system strongly influenced by the underground economy, the decision to grow might require. Within this framework, the best policy choices seem to be those connected with long-term tax reliefs on investments and hiring costs, particularly those introduced by tax credits.

Chapter 6 is devoted to the relationship between banks and firms and to the financial constraints to firm growth. In Italy, external financings to firms are dominated by bank credit for fiscal, legal (the traditional fragmentation of the bank market) and “cultural” reasons (the entrepreneurs' diffidence towards financial sources, such as share issuance, which are considered instruments to reduce their firm control). The Chapter deals with the following questions: I) existence of credit rationing for SMEs; ii) the effects of the process of restructuring of the bank system; iii) possible effects of the so-called “Basilea II” agreements; iv) whether the financing to firm growth should draw from bank credit or whether alternative financial sources should be found. The data examined in the Chapter indicate that in Italy bank constraints to the financing and growth of SMEs concern more the cost of credit than its availability (even though there is a sort of credit rationing, particularly for Southern micro-firms). Besides, bank consolidation continues to worsen the conditions to have access to small business lending patterns, thus strengthening the fears raised by the enforcement of “Basilea II”. However, at the same time, the restructuring of the credit sector goes alongside with a more effective evaluation of the credit risk, thus inducing to wonder whether that process is the inevitable “price” paid in periods of change. This suggests that the problem of the financial constraints to growth of SMEs is not limited to the mere relation between credit demand and supply, but more generally depends on the conditions prevailing on the financial markets. Thus, the solutions are to be found on different levels, by acting both within and outside the bank-firm relationship: among the most promising solutions there are the strengthening of credit consortia and the promotion of private equities.

Chapter 7 of the Report is devoted to the analysis of administrative delays which have been characterising the Italian infrastructures by examining the past, present and future uncertainties of

the legislation on the implementation of great public works in Italy. The small density of infrastructures in Italy and its fair distribution on the territory are constantly indicated as the major factors hampering growth and, probably, firm growth. In particular, the Chapter investigates the procedures for the identification, location and planning of infrastructures.

Generally speaking, the situation of the existing legislation – comprising the “Merloni” Framework Law and the “Lunardi” Target Law and the Constitutional Reform of 2001 – may be still defined as confused and uncertain. To begin with, legal changes continue to follow one another with such a speed that they run the risk of not being even enforced. Secondly, the Constitutional reform makes the existing set of rules and regulations somehow uncertain. Indeed, on the one side, the new division of legislative and administrative competences requires an evaluation of the constitutionality of the existing legislation; on the other side, most national laws have a generalised enforcement till the new regional legislation is introduced.

Besides, as soon as the applicative provisions of the Constitutional Reform is issued (known as “La Loggia” Law), the need to “reform the Reform” is becoming all the more urgent (new Draft Reform, known as “La Loggia-Bossi” Law).

In particular, with reference to the legal framework depicted by the Target Law, it tends to avoid some distortions of the system of legislation. Apart from more effective mechanisms to gather new resources (for instance, through private capitals) which should be invested in works considered particularly important, the new legislation aims at creating a smoother mechanism of fund granting, thus finding a solution to the pathologically long procedure necessary for the evaluation and approval of projects.

Furthermore, the phases indicated by the “Lunardi” Law foresee a maximum term within which they must come to an end. Compared to the “Merloni” Law (which is however a novelty compared to the previous legislation), that legislation envisages a well-specified timing, so that the length of time necessary to accomplish the procedure is not only shorter, but also somehow fixed before.