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"On the threshold of the third millennium"

Growth of small and medium-sized enterprises and employment

Address by the Governor of the Bank of Italy

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It was with great pleasure that I accepted the invitation to take part in this debate held in the Marches, a region whose productive system is based to a considerable extent on small and medium-sized enterprises. Since the seventies industry in this part of the country has been notably successful in penetrating international markets and has recorded remarkable growth.

In several sectors Italian industry, including the component made up of small and medium-sized enterprises, has achieved a position of excellence and contributed to the country’s economic and social development.

1. An economy of small enterprises

The structure of production in Italy is dominated by small enterprises. According to census data, 94 per cent of Italian firms have less than 10 employees; in terms of employment, these firms account for 45 per cent of the total, which is more than twice the European average and compares with 20 per cent in Germany and France and around 30 per cent in the United Kingdom. Firms with less than 20 employees are estimated to have contributed 42 per cent of the value added in industry and non-financial services in 1995.

There are relatively few large companies in Italy; the share of total employment of firms with more than 500 employees is less than one fifth, compared with one third in Germany, France and the United Kingdom.

The sectoral composition of Italian industry also differs from that of the other leading European countries. It is specialized primarily in mature consumer goods and medium technology investment goods; capital intensive manufacturing and advanced production processes play a smaller role. The sectors in which the majority of Italian small and medium-sized enterprises operate are marked by relatively limited innovation, low entry barriers and a high price elasticity.

Italian firms are smaller than their counterparts in the rest of Europe on average, except in the car and office machinery industries.

The gap compared with other European countries is also wide for medium-sized enterprises. Those with between 100 and 499 employees provide less than 10 per cent of total employment in Italy, compared with 17.5 per cent in Germany, 16 per cent in France and 17 per cent in the United Kingdom. Analyses carried out by the Research Department of the Bank of Italy show that the limited importance of medium-sized enterprises is all the more striking when they are classified taking into account ownership patterns tying firms into group organizations.

The existence of a substantial stratum of medium-sized enterprises is a prerequisite for the emergence of large ones. Major discontinuities in the growth of firms are rare.

The large number of small businesses is also a reflection of the high level of self-employment. Italy’s 750,000 small enterprises with less than 10 employees and set up as companies are flanked by some 2,300,000 sole proprietorships.

At present nearly one third of those with jobs in Italy are self-employed, a figure that is without parallel in any other European country, except Greece. While the number of payroll workers rose by 2 per cent over the last two decades, the number of self-employed expanded by 17 per cent, with the bulk of the increase occurring in the period of intense industrial restructuring from 1981 to 1984.

The peculiarities of the structure of the Italian productive system are related to rigid tax, social security and labour laws, which encourage the fragmentation of production.

2. Profitability and financial structure

Analyses based on figures published by the Italian Company Accounts Data Office show that the operating profits of small and medium-sized enterprises are high, partly owing to the lower level of employee compensation they pay on average. The gross operating margin of firms with less than 10 employees in 1997 was equal to 70 per cent of value added; for firms with between 10 and 19 employees it was 54 per cent and for the sample as a whole it was 43 per cent.

The higher operating profits of smaller firms are largely offset by their higher financial costs. Despite the fall in interest rates in recent years, from which smaller borrowers have also benefited, such costs still amount to more than one third of the operating margin of the smallest firms, as against 17 per cent for firms with more than 1,000 employees.

The heavy burden of financial costs borne by small firms reflects their substantial recourse to debt capital, especially bank credit, most of which is short term and often in the form of overdrafts. This reduces the flexibility of their investment choices and makes for greater financial fragility in adverse phases of the business cycle. During the 1993-94 recession more than half their operating margin went to pay the interest on their financial debt.

In the nineties the financial debt of firms with less than 10 employees was always more than 230 per cent of their value added. For large enterprises it fell sharply, both in absolute terms and in relation to shareholders' equity, partly owing to the privatization of large public enterprises. The leverage of companies with more than 1,000 employees fell from 134 per cent in 1990 to 89 per cent in 1997.

Bank credit amounts to 73 per cent of the total financial debt of firms with less than 10 employees, as against 55 per cent for larger companies. Bond issues are negligible for all enterprises; commercial paper and investment certificates are little used, despite the regulations governing their issue now having been in force for more than five years. The small volume of financing based on debt securities is also evidence of the insufficient number of intermediaries, widespread in the Anglo-Saxon countries, specialized in financing small enterprises with good growth prospects.

The foregoing pattern of financing small enterprises is not peculiar to Italy, however; nor is it a recent phenomenon. As long ago as 1931 in the United Kingdom the report of the Macmillan Commission identified a "finance gap" in the growth path of small enterprises; it highlighted the difficulties small firms encounter, once they have exhausted the scope for obtaining bank credit, because they do not possess the requisites for gaining access to sources of longer-term finance.

Even in the most highly developed markets the smallest and youngest firms finance their growth primarily with internally generated resources. It is only when they reach an adequate size and reputation that they turn to bond and share issues. A structure of liabilities skewed towards debt capital may prevent firms from grasping good investment opportunities and thereby diminish their growth potential.

Over the years the problem of the finance gap has been tackled in several different ways, based variously on institutions, legislation and markets. In Germany public institutions were set up in the immediate postwar period to help small and medium-sized enterprises obtain access to bank credit and foster recourse to medium and long-term borrowing. The French authorities followed a course characterized by the centralization of the allocation of financial resources through the development of a series of specialized intermediaries, often of a public nature, with local banks left to play only a minor role.

The response in Italy was based for a long time on the supply of medium and long-term funds by special credit institutions; it was also marked by the importance attributed to local banking and the development of relationships between local banks, mainly savings and cooperative banks, and small enterprises.

In the Anglo-Saxon countries the response consisted primarily in the development of investment banking, especially with the birth of intermediaries, such as venture capital companies, and markets, such as NASDAQ, specialized in financing small innovative companies with a high growth potential.

In order to overcome the problem of the finance gap, Italy will also have to move resolutely towards a more market-oriented system. The 1993 Banking Law permits this change; the new conditions of pronounced cyclical swings, structural changes and the complete opening of the economy to international competition make it necessary in order to meet the need for flexibility in the organization of production and the financing of firms.

3. Industrial districts and the labour market

The geographical distribution of Italian small and medium-sized enterprises is notable for the presence of industrial districts, agglomerations of enterprises that in many respects resemble the models of production found in nineteenth century England and described by Alfred Marshall. The organizational pattern is significantly different from those of large enterprises and small independent firms. The production process benefits from being divided among many small workshops, each of which specializes in a single phase.

There are nearly 200 such districts in Italy: 125 in the regions of the North-East and Centre, of which 35 are in the Marches alone; 59 in the regions of the North-West and 15 in those of the Mezzogiorno. The employment provided by the firms engaged in the production typical of these districts was equal to 13 per cent of total manufacturing employment in 1994. When the other manufacturing companies present in the same areas are added in, the proportion rises to 42 per cent nationwide, with a high of 60 per cent in the North-East and a low of 10 per cent in the South.

The share of exports of industrial products that can be attributed to the areas in which industrial districts are located rose from 43 per cent in 1991 to 47 per cent in 1997.

This model of production has attracted interest in view of its ability to combine competition and cooperation.

Fierce competition between firms is a consequence of their closeness, which encourages observation of competitors' choices; in addition to the drive to emulate other firms there is the stimulus stemming from the desire to succeed.

Industrial districts are characterized by a highly developed civic culture, whose principles sometimes date back to the city states of the twelfth century. The high level of “social capital” is a public good based on efficient local administration, widespread participation in voluntary associations, civic spirit and fruitful cooperation between public and private bodies; it is the result of a slow process of sedimentation and accretion; it underpins the mutual confidence that fosters the exchange of information and strengthens solidarity and cooperation.

The fact of belonging to an integrated system of enterprises appears to diminish the fragility of participants and to reduce the high birth and death rates typical of small and medium-sized enterprises.

Enterprises in industrial districts benefit from the social capital and positive externalities linked to the local environment and to the exchange of knowledge, in part through the labour market, which is rich in professional expertise.

These enterprises rely to a considerable extent on a high degree of flexibility in working practices. They succeed in matching professional tasks and qualifications closely and make extensive use of apprentices and homeworkers. More blue-collar workers are women, who earn less owing to their lower qualifications and grades. As a rule, enterprises in industrial districts provide openings for the young to enter the labour market and to complete their vocational training; the average age of newly-recruited staff is lower in such firms.

The competitiveness of Italy’s industrial districts does not depend on low wages; where the professional skills are of high quality, wages and other conditions of employment appear to reward workers better than elsewhere.

Wages rise as employees' technical knowledge increases. The higher productivity typical of workers in industrial districts derives from mobility as well as the organizational model. Human capital tends to grow rapidly; the experience gained allows staff to reach positions of greater responsibility within the firm or in other local firms or by working in a self-employed capacity. Employees work harder and try to learn quickly, sometimes with a view to turning themselves into entrepreneurs and setting up a business of their own.

Flexibility, together with the ability to match compensation and productivity more closely, allow enterprises in industrial districts to adapt better to the business cycle and to be more profitable. The advantage with respect to "isolated" enterprises can be considered as between two and four percentage points in terms of the return on equity and investments.

In the South of Italy there are still only a few industrial districts. Firms' birth and death rates are higher. Businesses tend to remain very small, owing both to the limited size of the local markets and to their lower productivity and profitability.

The way in which government incentives worked in the past under the special measures for the development of the South resulted enterprises located there having better balanced liabilities, with a larger proportion of equity capital and long-term debt than their counterparts in the rest of the country. The advantages they gained from such financing were nonetheless offset by a lower level of productivity.

Today, the indebtedness of the smallest enterprises is higher in the Mezzogiorno. Financial costs remained high in the nineties as a ratio to operating margin. The greater fragility was reflected in the quality of the assets of banks located in the area.

There are signs of an improvement in the situation. Southern industry is becoming more diversified. Along the Adriatic coast and in some parts of Campania and Lucania there is evidence of the formation of groups of companies that could give rise to industrial districts.

The exports of southern enterprises have increased considerably; sales abroad exceeded 30 per cent of total turnover in 1998.

4. Large and small enterprises in recent decades

The burden of sustaining and fostering production and innovation has been borne alternately by large and small enterprises. In the seventies it was large enterprises, both public and private, that were hit by the effects of the oil shocks and that ran into financial difficulties. During those years it was the vast web of small and medium-sized enterprises that ensured the maintenance of employment in large parts of the country.

Large enterprises were excessively rigid, so that smaller firms enjoyed competitive advantages. It was that decade which saw the birth of the organizational model known as “flexible specialization”, made possible by technological innovation and based on constellations of small production units.

The comparative advantage shifted back to large enterprises in the eighties. Italy’s large firms reorganized their production processes, increased their efficiency and flexibility, restored conditions of profitability and put their finances back on a sound footing.

The position of small enterprises remained satisfactory in the new situation, in terms of profitability, productivity and investment. A large body of entrepreneurs, able to respond promptly and effectively to changes in market conditions, was one of the strengths of the Italian economy in the adverse phase of the business cycle of the early nineties.

A long tradition of economic thought sees innovation as related to firm size. Radical and inherently more costly technological innovation capable of leading to new products is the preserve of large firms.

In Italy, far-reaching changes in relative prices, technology and industrial relations have created conditions in which firms of small size are at an advantage in terms of organizational structure, operational flexibility and speed of adaptation to changes in demand, factors that have all helped to offset the potential disadvantages deriving from the more limited scope for such firms to enjoy economies of scale.

The competitiveness of an economy also depends on innovation being widely diffused and on its being exploited in the various ways that the creativity of small entrepreneurs is capable of devising. Italy’s small enterprises have performed this role to the full and have themselves often become sources of innovation, especially of an incremental nature. The danger of economic power becoming highly concentrated is reduced if there are many entrepreneurs and new ones can enter the market and expand their businesses.

Small enterprises are a potential means of achieving economic and social growth.

5. Flexibility for growth

Far-reaching adaptation is necessary in the face of structural changes. The ability to adjust must be widespread among firms, workers, financial intermediaries and public authorities. Growth requires a virtuous interaction between institutions, individuals and organizations.

In the new context of monetary integration, the international mobility of capital is complete; the competition between national economies increasingly calls for the ability to raise productivity by the diffusion of technological innovation.

Italy is facing the changes under way with an economy still marked by rigidities and weaknesses. The uncertainty associated with the structural changes enhances the value of the ability to adapt to the requirements of demand and combine the factors of production flexibly. It is against this background that the outlook for the growth of the Italian economy and the role of small enterprises should be analyzed.

Between 1970 and the mid-nineties Germany, France and the United Kingdom diversified their productive structures and strengthened their positions in numerous sectors with a medium or high level of value added. By contrast, other countries, such as Spain, Italy and Portugal, significantly increased their specialization in just a few sectors; in Italy and Portugal these were all marked by having a low value added per employee.

In the Italian economy the relative importance of mature sectors increased from an already high level; that of high technology sectors decreased. The share of value added generated by industries paying high wages contracted.

Italy's economy has a low degree of internationalization compared with those of the other leading industrial countries. The share of international direct investment coming to Italy has been low for many years. The direct acquisition of new technologies through inward and outward investment is limited.

Specialization in forms of manufacturing with a small technological content carries a risk, because they are exposed to competition from products originating in countries with low labour costs and less demanding social and environmental regulations. Overall, Italian industry has managed to achieve good results; in the medium term, however, the difficulty of developing new sectors may adversely affect its growth potential.

The development of more advanced sectors requires human capital to be enhanced, in part by increasing the average level of educational accomplishment. It is necessary to encourage research, strengthen the links between research in universities and the productive sector, and foster the diffusion of technological innovation.

The limited expansion of smaller firms and the low number of medium-sized firms are evidence of the presence of barriers to growth.

The existence of so many firms with just a few payroll workers and the extensive use made of the self-employed are typical of industrial models in which the preferred choice is to sub-contract and outsource what would be too costly to produce internally. This tendency partly reflects the opportunities created by new technologies, but it is also evidence of the burdens on firms that discourage their internal growth and vertical integration.

The decentralization of important phases of production to small firms, which often slip through the tax net, and the use of the services of self-employed workers, who often lack even the minimum of social security, are indicators of a regulation of the labour market that constrains personnel management and limits the action of market forces in determining wages.

The proper working of the labour market does not depend only on the variables that are typical of its operation, such as wages, forms of employment and working hours, and the manner of taking up and leaving jobs, but also on the ways in which social security is provided. Reforms and improvements capable of leading to stable equilibria must be accompanied by an increase in the efficiency of the welfare state, of the various protective nets. There is a need for equity for those who desire to attain regular forms of employment.

The Government and Parliament are moving towards a reform of the arrangements governing the welfare state.

The organizational flexibility that firms seek to achieve by using self-employed workers and fragmenting production is also evidence of the need to simplify the law governing firms and broaden shareholders' powers of choosing. The provisions of company law do not always meet the needs of small and medium-sized enterprises, where the problems of protecting shareholders are less pressing.

The reform must be based on full recognition of the role of entrepreneurs in guiding and managing enterprises, encourage the birth of new entrepreneurial initiatives and the growth of small firms and their adoption of more open corporate forms, reduce transaction costs and diminish the risk of potentially salvageable firms being placed in liquidation.

In view of the peculiarities of Italy's productive system and its polarization in terms of firm size, it is important to increase the adaptability of companies' legal configurations by reforming the existing models and allowing greater freedom in corporate charters.

6. Banks' contribution

Adequate methods of financing can contribute to the growth of Italy's small and medium-sized enterprises and improve their ability to react to increases in the cost of credit and shortages in its supply.

The practice of borrowing from multiple banks is prevalent; the recourse to a large number of intermediaries weakens customer relationships and thus increases the probability that firms in financial distress will have difficulty in raising the funds they need at a sustainable cost in moments of tension. Firms rarely have direct access to the market by issuing debt instruments such as commercial paper and bonds, which can offset temporary difficulties in obtaining bank credit.

By fostering the reduction in leverage and the lengthening of the maturity of debt, the return to monetary stability and the reduction in the cost of capital can be a powerful incentive for firms to rebalance their financial structures. Another factor acting in the same direction is the recent reform of the tax system, which, with the introduction of dual income tax and the regional tax on productive activities, has linked easing of the tax burden with increases in equity capital and reduced the incentive to rely on debt capital.

Financial intermediaries will have to accompany this process and enable firms to benefit from the tendency of households to lengthen the average maturity of their portfolios and increase the proportion made up of shares. Italian banks, directly or through specialized companies, will have to channel saving towards innovative forms of financing of smaller firms and provide access to the capital market for those wishing to tap it, up to the point where they obtain a listing.

Italian savers' increasing recourse to foreign markets is largely due to the unsatisfactory development of the domestic securities market.

The Italian model of intermediation, which combined a solid network of banks operating on a nationwide basis and often owned by the state with local banks and a nucleus of intermediaries specialized in medium and long-term finance has changed in the last ten years. The intensification of both domestic and foreign competition, the elimination of the segmentation of operations, the process of consolidation in the industry and the reduction in public ownership are leading to a more efficient structure that is more in line with the evolution of international markets.

The liberalization of banking and the definitive abandonment of public subsidies for bank financing of investments make it necessary to develop the securities market, especially the stock market, and market instruments able to support the growth of small and medium-sized enterprises.

The new macroeconomic context and the globalization of finance are opening up new prospects. Medium-sized firms can profit from these to grow in size if they overcome their reluctance to allow new shareholders to participate in their capital.

It is necessary to capitalize on the advantage represented by the high level of Italian households' saving and keep it within the country's productive system.

7. Employment

Between 1990 and 1998 GDP grew in Italy at an average annual rate of 1.2 per cent, or at about half the rate recorded in the preceding decade; the average rate of growth in the other EU countries was 2.1 per cent.

The shortfall in growth translated into an unsatisfactory employment performance. Between 1991 and 1997 the number of persons in employment decreased by 1.1 million units, above all owing to the falls in the building industry and agriculture. In 1998 there was an increase of 0.5 per cent.

Employment has contracted in large industrial firms; between 1991 and 1997 the number of payroll workers in such firms declined by more than 250 thousand units. In smaller firms the number increased by 170 thousand units.

In order to return Italy back to a growth path, it is essential to proceed with the efforts being made to increase the competitiveness of the economy. The machinery of government and the tax system must be made more efficient. Procedures must be streamlined, where necessary by adopting extraordinary measures.

Of decisive importance will be the strengthening of the educational system and the boosting of investment in the sectors of research and technological innovation.

In order to grasp the opportunities offered by the integration of markets, innovative investments by Italy's large enterprises are required.

Small and medium-sized enterprises are an important, essential part of Italy's productive system. Removing the constraints that hinder their activity will allow them to focus their inventiveness and adaptability on increasing efficiency and productivity.

Smaller firms are a source of entrepreneurial ability and economic vitality; their growth can lead to the creation of new jobs.

It is in the present phase that the foundations must be laid for the productive structure of the years to come.

Incomes policy, both for large enterprises and for small and medium-sized enterprises, must conform with criteria of efficiency that translate in practice into a close correspondence between labour costs and productivity at the regional, sectoral and company levels.

The adjustment of total compensation must make it possible to tackle, without prejudice to employment, the swings in the business cycle and structural changes.

Italy has the resources, in terms of entrepreneurial and professional skills, young workers and savings, with which to respond successfully to the new, more competitive, global environment.

It is up to the political sphere and all those who contribute to the formulation of economic policy to capitalize on those resources.

It is both necessary and possible for the sake of development to combine, in a medium-term perspective, the completion of the return to sound public finances with the necessary structural reforms.

These are the conditions for giving certainty to the prospects for the future, endowing the Italian economy with a new competitiveness, strengthening confidence and achieving a significant increase in employment.

Firms will not hold back, in such conditions, from contributing to the recovery in investment, for the wellbeing of present and future generations.