Zombie firms and weak productivity: what role for policy?

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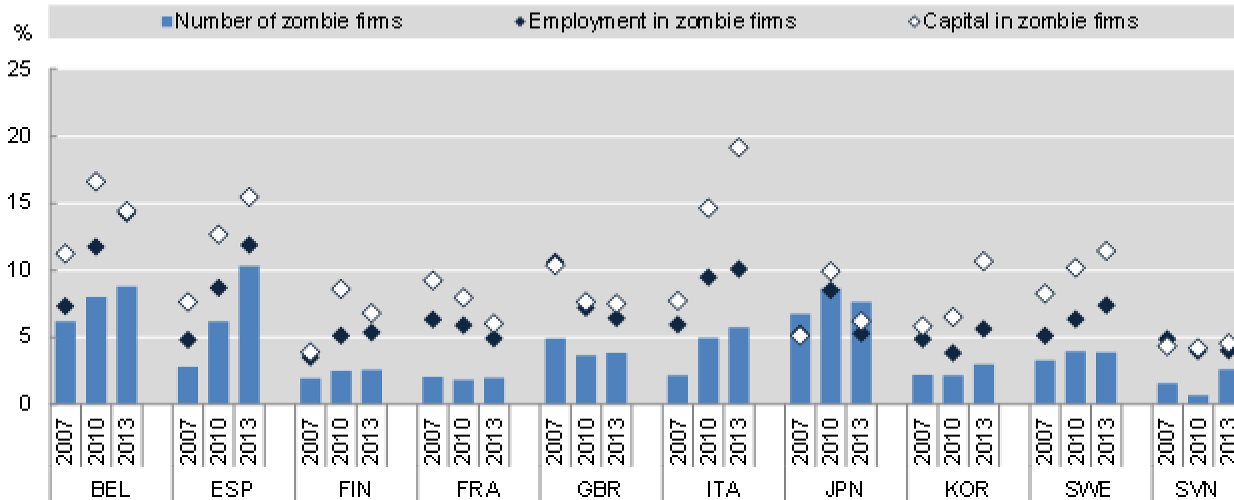
Weak productivity growth is a major problem afflicting our societies. It curbs growth in incomes and endangers the sustainability of our social security systems. An important, but often ignored, source of the productivity slowdown is the increasing prevalence of weakly productive firms and, among them, "zombie firms" – i.e. firms that would typically exit or be forced to restructure in a competitive market. In this context, a new OECD study shows that this prevalence is closely related to weaknesses in the banking system and insolvency regimes. It argues that reviving productivity growth will partly depend on the policies that restore banking health and effectively facilitate the exit or restructuring of weak firms, while simultaneously coping with any social costs that arise from a heightened churning of firms and jobs.

The problem

The prevalence and productive resources sunk in "zombie" firms – defined as old firms that have persistent problems meeting their interest payments – have risen since the mid-2000s in a number of OECD countries (Figure 1). In Italy, for example, the share of the industry capital stock sunk in zombie firms rose from 7% to 19% between 2007 and 2013. Zombie firms represent a drag on productivity growth as they congest markets and divert credit, investment and skills from flowing to more productive and successful firms and contribute to slowing down the diffusion of best practices and new technologies across our economies.

The rise of zombie congestion



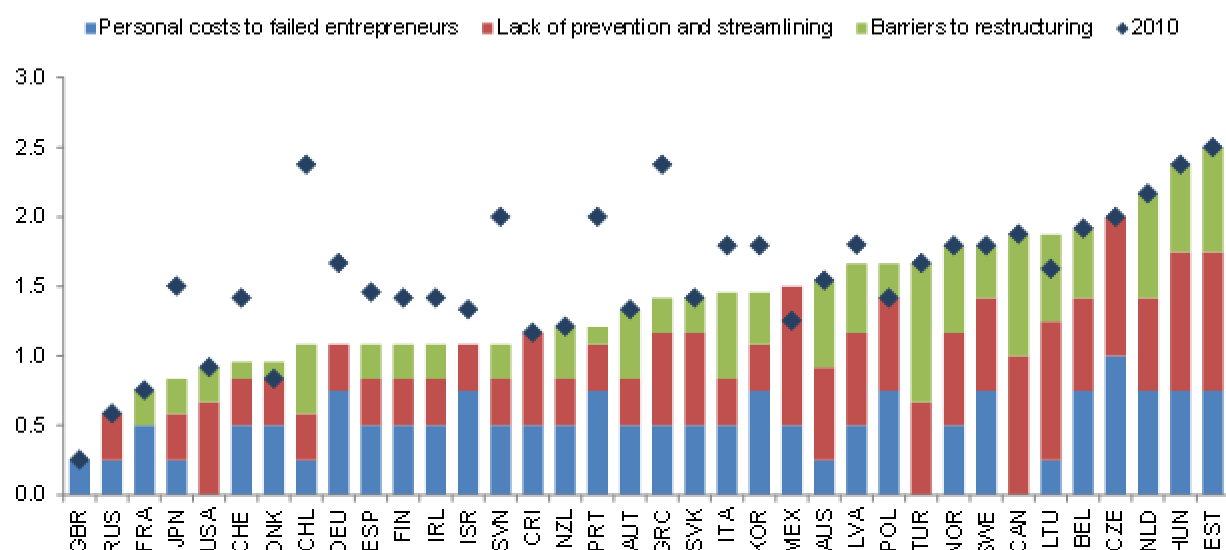
Note: Firms aged ≥ 10 years and with an interest coverage ratio<1 over three consecutive years. Capital stock and employment refer to the share of capital and labour sunk in zombie firms. The sample excludes firms that are larger than 100 times the 99th percentile of the size distribution in terms of capital stock or number of employees.
Source: Adalet McGowan, Andrews and Millot (2017).

Data from figure available here.

What can policy do?

New OECD indicators suggest that there is much scope to improve the design of insolvency regimes to accelerate the restructuring or exit of weak firms and thus revive productivity growth (Figure 2). For example, insolvency reforms that reduce barriers to corporate restructuring and the personal cost associated with entrepreneurial failure could translate into a decline in the zombie capital share of at least 9 percentage points in Spain, Italy or Portugal – countries where the zombie capital share stood at 28%, 19% and 16% in 2013, respectively. The good news is that in recent years insolvency reforms have already taken place in a number of countries, which are likely to partly achieve some of these gains.

Barriers to exit or restructuring imposed by insolvency, 2010 and 2016



Note: The stacked bars correspond to three subcomponents of the insolvency indicator in 2016. The diamond corresponds to the value of the aggregate insolvency indicator based on these three subcomponents in 2010.
Source: Adalet McGowan, Andrews and Millot (2017).

Data from figure available here.

Zombie firms are more likely to be connected to weak banks, suggesting that zombie congestion partly stems from bank forbearance – i.e. the tendency for weak banks to bet on the resurrection of failing firms. This underscores the importance of a more aggressive policy to resolve non-performing loans, but this can only be truly effective if accompanied by complementary reforms to insolvency regimes. Distortions in the banking sector also highlight the importance of market-based financing instruments for productivity growth, with the inherent debt bias in corporate tax systems and the lack of venture capital financing emerging as key barriers to technological diffusion.

Finally, reforms that accelerate corporate restructuring should be coupled with policies to manage the social costs of worker displacement. Job search and retraining programs turn out to be effective in returning workers displaced by firm exit to work, particularly in environments where barriers to firm entry are low as this stimulates job creation.

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