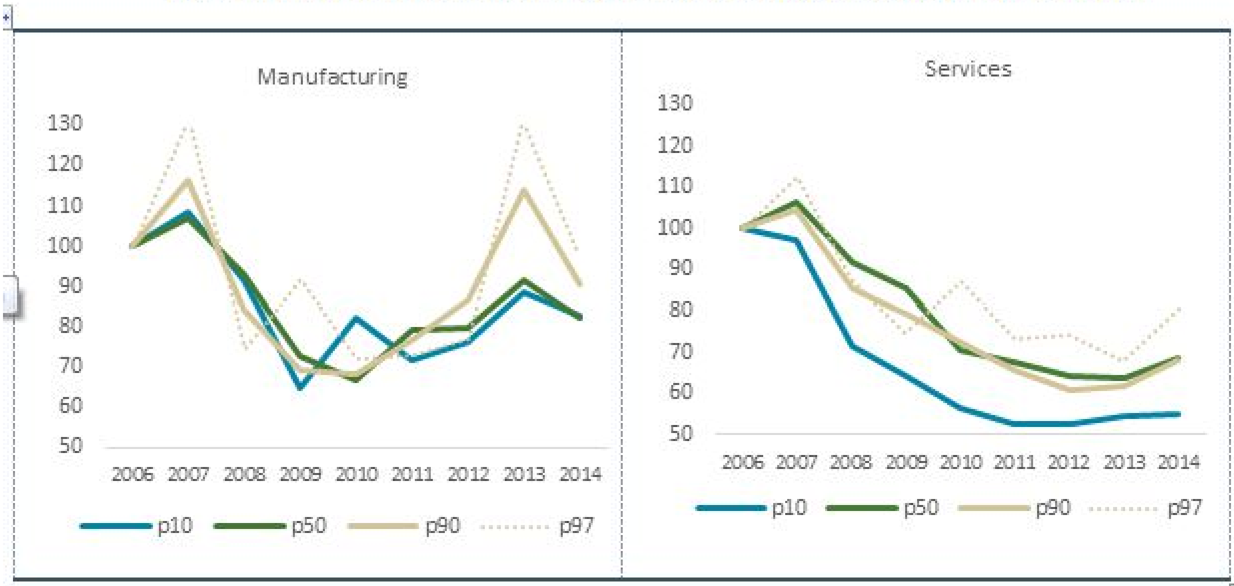
Unblocking the productivity potential of local businesses in Ireland

By Yosuke Jin and Ben Westmore, Ireland Desk, OECD Economics Department.

Irish GDP growth made headlines recently due to enormous upward revisions (e.g. + 25.6% for the sole year of 2015) related to the activities of a small group of multinationals. This raises the question of how much Irish productivity relies on multinational companies alone. In fact, while it has not made headlines as much as the GDP revisions, the divergence in productivity performance among firms in Ireland over recent years is particularly striking. This matters a lot for the sustainability of Irish living standards.

New firm-level analysis undertaken in tandem with the *OECD Economic Survey of Ireland 2018* finds that the majority of businesses in Ireland have actually experienced falling productivity since the mid-2000s (Department of Finance, 2018). This analysis also identifies rising dispersion in the productivity between top-performing firms and other firms in most industries (Department of Finance, 2018: Figure 1), with most top-performing firms being multinational enterprises (MNEs). Indeed, a rise in aggregate productivity observed in official statistics has relied on a small group of very large successful firms, most likely the same ones whose activities have been chiefly responsible for the eye-catching GDP outturns of recent years.

Figure 1. Trends for top, median and bottom decile of labour productivity distribution



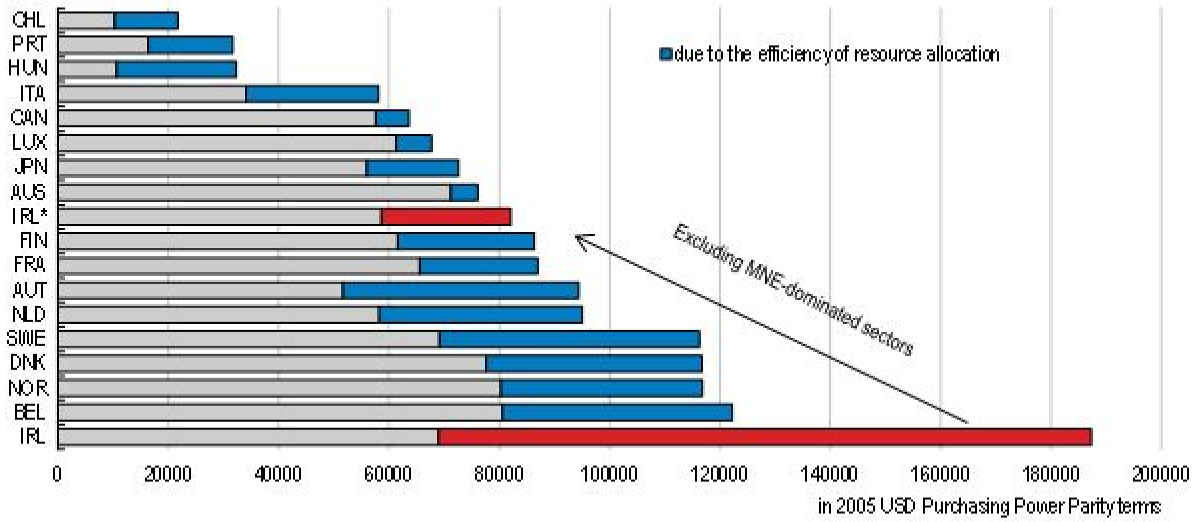
Note: The chart shows the evolution of labour productivity at some selected percentiles: namely the 10th, 50th, 90th and 97th percentiles. All percentiles have their productivity levels in 2006 normalised to 100, in order to see their relative paths in the following years.

Source: Department of Finance (2018) based on the MultiProd dataset (more details on the MultiProd distributed microdata project can be found at http://www.oecd.org/sti/ind/multiprod.htm).

At first glance, the efficiency of resource allocation in Ireland appears to be very high (Figure 2). However, this result owes largely to the presence of MNEs that can raise a huge amount of resources from different channels. Once the MNE-dominated sectors have been excluded, the efficiency of resource allocation in the Irish economy is greatly reduced and is close to the average of other OECD countries (Figure 2).

Figure 2. Capacity of productive firms to grow is weaker for local firms

Labour productivity of firms in the manufacturing sector



Note: The Olley-Pakes decomposition used in MultiProd decomposes aggregate productivity into the contribution of two terms, an unweighted productivity term representing average firm level productivity, and a covariance term that links productivity to firm size (defined by employment shares). The latter term (known as the OP gap) is a measure of allocative efficiency, since it increases if more productive firms capture a larger share of resources in the sector:

$$P_t = \frac{1}{N_t}\sum_i P_{i,t} + \sum_i (\theta_{i,t} - \bar{\theta}_t)(P_{i,t} - \bar{P}_t)$$

P_t is sectoral level productivity at time *t*, *N* represents the number of firms in a sector, $\theta_{i,t}$ is the share of firm *i* at time *t*, $P_{i,t}$ is the productivity of firm *i* at time *t*, and $\bar{\theta}_t$ and $\bar{P}_t$ are sectoral averages. "IRL" in the above figure covers all firms including multinational enterprises (MNEs); "IRL*" excludes those in the MNEs dominated sectors.

Source: Department of Finance (2018) based on the MultiProd dataset.

Recent OECD studies show that non-viable firms (i.e. those kept alive by forbearance loans but otherwise insolvent) have reduced the investment and employment growth of healthy businesses in many OECD countries over the past decade (Adalet McGowan et al., 2017). In Ireland, SME default rates are among the highest in the euro area countries, while forbearance has frequently been granted to defaulted loans, which instead could be reallocated to enable highly-productive businesses to expand (OECD, 2018). This could be a major explanation of the lower productivity of domestic firms.

Another key channel through which productivity gains occur is via knowledge spillovers from top, "frontier" firms. Given Ireland's high share of multinational enterprises, there is potential for virtuous productivity spillovers from high-productivity foreign firms to local businesses. However, such spillovers cannot be taken for granted. Other firm-level empirical analysis undertaken in tandem with the OECD Economic Survey of Ireland 2018 finds that such knowledge spillovers are overall limited in Ireland and local firms are even crowded-out by MNEs in some instances (Di Ubaldo, Lawless and Siedschlag, 2018).

What explains these limited spillovers? First, trade linkages, expressed as the intensity of supply chains between foreign- and locally-owned firms, are weak (OECD, 2018). Moreover, the productivity gains of such linkages can only be fully realised if local firms have the capacity to absorb the new ideas and technologies utilised by frontier firms, which requires investment in knowledge-based capital and human capital by local firms. For example, the above mentioned analysis shows that trade linkages produce positive productivity spillovers for those local firms that exhibit high absorptive capacity, captured by R&D investment (Di Ubaldo, Lawless and Siedschlag, 2018).

Could local firms take greater advantage of the performance of multinational enterprises? Policymakers should promote reforms that encourage the absorptive capacity of local businesses. At present, the capacity of local firms to absorb and implement new technologies is impeded by relatively weak managerial skills. This partly reflects the low proportion of workers participating in lifelong learning activities. With burgeoning skill demand, there should be an increase in the share of training funding to those in employment. Innovation and the ability for Irish firms to fully utilise new technologies is also weakened by low research and development activities. There is scope to reorient innovation policy to better promote the research intensity of local firms. In particular, targeted public grants for business research and development could be increasingly used, as it would better reach local entrepreneurs that may be in a loss-making position and hence less swayed by tax exemptions on research funding.

Finally, the OECD Economic Survey of Ireland 2018 argues that, beyond spillovers, the productivity potential of local businesses can be raised through reducing regulatory barriers to entrepreneurship and the costs of business failure. Access to finance for young firms needs to improve as well and will benefit from further efforts that mend the health of the banking sector and raise the efficacy of state-supported lending initiatives. Further improvements in Irish infrastructure will also promote firm growth. The government plans to increase capital spending significantly over the coming four years and the projects undertaken must continue to be carefully prioritised through evidence-based evaluation of those with the highest returns. To do this more effectively, systematic collection of information on the performance of existing assets is crucial.

References:

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