Stimulating business creation: Analysis and proposals

Although the Spanish government has focused on average enterprise size as a means of closing the productivity gap, studies show that it is productivity that determines size. In order to spur business creation, more attention should be paid to those factors that shape the internal costs of growth in Spain.

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Abstract: The Ministry of Economic Affairs and Digital Transformation has published a document titled "Measures for Fostering Business Creation and Growth" that argues in favour of increasing the average size of Spain's enterprises to close the productivity gap. But many studies show that it is not company size that determines productivity levels but productivity that determines size and that the breakdown of a country's enterprises by size segments is the result of market discipline, competition and management practices. Although the government argues that the minimum capital required for setting up an LLC is an impediment to business creation, reducing this amount could send a misleading message to start-ups about the real financial needs of going into business. More attention should also be paid to the employer and management training market in Spain and the gap in formal education between the two. In terms of regulations relating to enterprise size thresholds, it may be necessary to review these but such a review should be approached from a broad perspective that takes general-interest goals into account. Lastly, business

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creation policy underestimated the internal costs of growth. As a first step in taking them into consideration, the government could benefit from commissioning a white book on management practices in Spain.

Introduction

In February 2021, Spain's President, Pedro Sánchez, unveiled a report titled "Spain: An Entrepreneurial Nation", which is considered key to articulating and supporting the country's social and economic transformation. Elsewhere, the Ministry of Economic Affairs and Digital Transformation has published a document titled "Measures for Fostering Business Creation and Growth" for public consultation. That document highlights the over-representation of smaller-sized enterprises and the high number of self-employed professionals as a hallmark structural characteristic of the Spanish economy. It further states that that atomised structure is largely responsible for Spain's productivity gap, positing that increasing the average size of Spain's enterprises would be an effective means of closing that gap.

This paper has a double objective. Firstly, to analyse the transaction costs incurred in the process of starting up a company. And secondly, to evaluate the Ministry of Economic Affair's diagnosis of the state of business creation and enterprise size structure in Spain and the reform proposals made on the basis thereof. The rest of the paper presents some thoughts about specific aspects addressed in that document.

Diagnosis of the situation

Entrepreneurship and business creation have been the subject of economic policy debate in Spain for some time. An important first distinction to make when analysing business creation and development is between the quantity and quality of business creation. That distinction tends to bear a close relationship with the reasons for starting a business: self-employment, driven by the conviction that it is not possible to find suitable salaried work (*i.e.*, out of necessity), or, to the contrary, when those who do have opportunities for salaried work believe they can be more productive by setting out on their own (*i.e.*, opportunity-driven business creation). If the goal of public policy is to lift the economy's productivity and potential output, then clearly it is best to stimulate opportunity-driven business creation. If, on the other hand, the idea is to increase the number of people in work, the distinction between quantity and quality may be less important from the public policy perspective.

On the robustness of the general diagnosis

The document for consultation notes that Spain presents a higher percentage of smaller companies than those European countries with higher labour productivity rates. Framed by that paradigm, the main argument is that it is desirable to increase the average size of Spain's enterprises as a means to boosting the economy's productivity. The work by De Castro and Larraza (2018) characterises business creation and shows how the process is similar in Spain to that of benchmark countries, such as Germany and France. However there are some singular differences with those countries. For example, the enterprises created in Spain have lower growth expectations and are far less export minded. The average size of start-ups in Spain is very small, half of all start-ups disappear within five years and those that survive remain small in size (not much bigger than at the outset) in subsequent years. Evidence therefore suggests that it is not hard to create a new business in Spain; what is hard is innovation-driven business creation.

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Moreover, in relation to the debate about company size and its consequences, there is abundant international and national literature (Moral-Benito, 2016; Huerta y Salas, 2014 and 2018; Bloom *et al*., 2007 and 2014) that the cause-and-effect relationship, if it exists at all, is not that size shapes productivity but rather that productivity determines size. In other words, it is the more efficient and productive enterprises that gain market share and size, whereas less productive firms lose market clout.

It is also worth pointing out that the breakdown of a country's enterprises by size segments is not arbitrary but rather the result of market competition and management practices. It is therefore important to correctly diagnose why Spanish companies have the size they have and to assess the nature and ambition of the business ventures launched in order to understand why they continue to have such a limited impact on productivity and scale.

On the objectives to be pursued

Peer-reviewed academic studies (Bloom *et al*., 2010 and 2014) show that the productivity differences associated with the quality of management practices have a more than proportionate impact on company size, so that by increasing the average quality of those inputs, average enterprise size and productivity increase more than proportionately. That evidence suggest a shift in attention away from legal persons (companies) or productive plants, the number of establishments in existence and their size to obtain a better understanding of the profile of the country's entrepreneurs-employers and the skills and educational backgrounds of their executives and the teams they manage.

On institutional factors

Analysis of business dynamism in Spain using the DIRCE database (The National Statistics Office's Database of Business Demographic Statistics) evidences that the rates of business destruction, creation and net survival (Fariñas and Huergo, 2015; García Perea, 2020; Huerta and Salas, 2021; and Xifre, 2019) are highly sensitive to the economic cycle. This shows that the creation and closure of businesses acts as an adjustment mechanism in the face of changes in demand when, in a bid to shore up productivity, it would be far preferable for cyclical adjustment to involve the redistribution of man hours across existing firms.

The database analysis also reveals that the breakdown of Spanish enterprises by size and the number of people employed by each size segment has barely changed since the early 1990s. Over that period, there have been considerable changes in technology, regulations and market dynamics but the size and employment breakdowns have remained constant. We can therefore infer that the rigidity of that structure is attributable to more structural factors than those alluded to in the government's document for public consultation.

Measures for facilitating business creation

Reducing the minimum level of capital needed to incorporate a LLC to one euro

The government's document claims that there are indications that the minimum capital requirement for setting up a limited-liability company (LLC) of 3,000 euros may be a significant impediment to business creation but does not specify how this impediment works. To create a business, it is not necessary to set up a company (legal person) to intervene between the entrepreneur, a natural person, and the third parties he or she contracts with. Incorporating and interposing a legal person is a decision that comes after a natural person discovers a business opportunity and takes

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action to secure the inputs needed to take advantage of it.

Among the legal structures an entrepreneur can choose from to conduct business with third parties, those that confer limited liability privilege are of particular importance. By limiting liability to the equity of the company created, the personal wealth of the entrepreneur is ring-fenced from the risk of business failure. Legal structure also facilitates the allocation of risk between multiple financial investors, enabling investments of larger scale while allowing each investor to maintain a degree of wealth diversification.

We believe that any decision to eliminate the minimum LLC capital requirement of 3,000 euros would need to be thoroughly substantiated. To assess the suitability of a minimum capital requirement in addition to general-interest considerations (society may view that the limited liability privilege should be associated with a social return from the enterprise created, beyond the private return), it is necessary to contemplate the market logic. The equity of a corporate enterprise is an important indicator of the guarantees the legal person brings to performance of the contractual obligations assumed with third parties.

Reducing the minimum capital of an LLC from 3,000 euros to one euro (as proposed in the government's document) would, in theory, cheapen the cost of setting up corporate enterprises for future entrepreneurs but it is important to consider whether this would increase the costs for the third parties that do business with them. Without a minimum capital requirement, the company would not provide any information about its equity and guarantees or about how much the person setting it up is willing to risk.

Lastly, reduction of the minimum capital needed to set up a company to one euro would send a misleading message to start-ups about the real financial needs of going into business. For technology or social innovation-driven ventures, the initial phase of investment is marked by significant uncertainty about the final outcome and significant asymmetry of information about the venture between 'insiders' and 'outsiders'. It is well known that uncertainty and information asymmetry complicate access to debt, especially bank debt, if not making it outright impossible.

It is obvious that for the types of enterprises that could help strengthen the business environment, reducing the minimum incorporation capital to one euro would not have any impact.

High financial and administrative costs of setting up a company in Spain

As noted, the evidence about the path of business creation in Spain is not consistent with the notion that the financial and

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administrative costs of setting up a business are excessive. If they were, the number of companies created would be comparatively lower than at present.

Business creation in the form of incorporation may pursue a range of objectives and it should not be taken for granted that the privilege that comes with setting up a company, and setting up an LLC in particular, will always be used in a socially responsible manner. In our view, reducing the legal minimum for setting up an LLC would not, on its own, have any meaningful impact on the ultimate goal, which is understood to be fostering opportunity-driven business creation.

Financial support measures for business growth

The government's document puts all the emphasis on corporate financing and ignores the first and most important step: the nature of the investment project needed to set up a business venture. Information asymmetry issues curtail such ventures' access to financing. The funds available and their cost are heavily conditioned on the difficulties faced by external investors in reducing uncertainty about the outcome of the ventures they are asked to finance and creating favourable conditions for controlling agency costs. It is hard to finance innovative start-ups and when financing is obtained it will generally come at a high cost in order to reflect the significant risk premium. Can we be certain, however, that the relatively lower weight of start-ups in Spain is attributable exclusively or above all to unique corporate financing issues?

It should not be assumed that the impediment to growth lies with a lack of financing without looking at the quantity and quality of innovative ventures the business sector can generate. Our vision of business creation acknowledges that the technology underpinning the venture or business model and the venture's competitive strategy are fundamental aspects of the business creation process. Through that approach, it is necessary to analyse the obstacles facing the innovation ecosystem in Spain to generate competitive projects.

Financial instruments are securities that regulate access to a company's cash flows and profits and also come with voting rights. There is a degree of consensus that many entrepreneurs prefer to retain control over the company they have created and 'reared' over the alternative of achieving higher growth at the cost of bringing in outside shareholders who would force them to share or cede that control. That matter, related with "managerial culture/quality", suggests the need to reflect on the professional background of management style in Spain. There is something amiss in the employer and management training market in Spain if, judging by the Eurostat data (Pérez and Hernández, 2013), the difference between the number of years in formal education of employers in Spain compared to the most productive countries in Europe is bigger than the difference in the number of years of education presented by employees as a whole.

It is also important to flag the significance of managerial capital in business growth. There is evidence (Rubio *et al.*, 2018; Garcés-Galdeano *et al.*, 2019; and García Olaverri *et al.*, 2006) that the value of any business endeavour in the financial markets will be largely determined by the value the market ascribes to the perceived quality, credibility and confidence of its management team.

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Measures to eliminate regulatory barriers to business growth

In recent years, the idea has taken hold in Spain and other countries (Garicano *et al.*, 2016), that companies face significant external costs in attempting to grow beyond a certain threshold of revenue and/or number of employees, as greater scale leads to higher tax transparency requirements and/or labour demands for collective representation [1].

In assessing the *external costs* of growth and company size in Spain, it is important to consider why the legislator set those thresholds in the first place. Those thresholds are part of public policies and regulations whose social cost-benefit analysis warrants discriminatory application to some companies and not others depending on their size. In such cases, there may be social efficiency reasons to justify leaving them in place.

Evidence suggests a considerable number of companies could try to alter their revenue or headcount figures in order to avoid more stringent tax oversight if their revenue tops the six-million-euro mark or having to set up a workers' committee if they employ more than 50 people. If this were the case, companies that, in the spirit of the law, should be on one side of the threshold would in practice avoid that marker. However, such socially reprehensible conduct is insufficient to conclude that the thresholds have effects on the average enterprise size of relevance in terms of efficiency and corporate productivity.

The enterprise size thresholds relate to the size of the legal person, whereas the relationship between size and productivity resides within the enterprise as a productive or organisational unit (management unit). A company may operate at an efficient production scale and/or leverage the economies of scale of sharing the same management team whereas its assets, productive units and employees may be divided among different legal persons. Formally, the enterprise does not reach the threshold and therefore eludes the labour and tax consequences of surpassing them, but productive efficiency is not affected.

The need to review the public policy and regulations conditioned by company size may be wholly justified but, in our opinion, should be approached from a broad perspective that takes general-interest goals into account.

However, the external costs of growth are not the only costs the legislator should examine. Business growth also entails *internal costs* that depend on the complexity of the coordination and motivation issues that come with increasing size within a given management unit and the organisational solutions taken to tackle them. In general, keeping costs under control when companies increase in size is achieved through internal organisational structures characterised by a higher degree of decentralisation and delegation of decision-making. For such delegation to work at least two conditions must be met: (i) the employees onto which the decisions are delegated must have the skills and training needed to perform the tasks they now need to pursue with greater autonomy; and, (ii) the person delegating the decisions must be convinced that that autonomy will be exercised in the organisation's interests and not the specific interests of the person(s) onto which they are being delegated.

In recent years, there have been a number of academic articles (Bloom *et al.*, 2014; Huerta and Salas, 2014 and 2017; Walk-Círculo de Empresarios, 2020) that have provided evidence of the relationship between confidence and delegation and the internal

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costs of growth for hierarchical companies. The relationship between the quality of management at companies and their ability to create decentralised environments of trust has also been established. In all countries, at consolidated firms, the management quality/ management practice input emerges first as a critical source of productivity and then as a capacity for growth. Therefore, in Spain, who owns a company and how they came to own this company ends up being decisive in the decision-making that directly impacts the organisation and the costs of growth.

Conclusions

Any legislative drive aimed at stimulating business creation and business growth should start by recognising the considerable differences between innovation-driven and necessity-driven start-ups. Public policy in support of business creation with a focus on productivity gains needs to be concerned with opportunity-driven business creation.

We believe that the range of choices afforded by existing regulations is sufficient for incorporating any kind of venture in the manner best suited to its needs (LLC, cooperative, PLC, *etc.*). We agree with the idea of unifying legislation on the minimum capital requirement for setting up a LLC but the legislator should bear in mind that the ultimate goal of the minimum capital regulations is not to reduce the cost of setting up a company. The goal should be to reduce the total transaction costs, private and social, of interposing a legal person with limited liability between the natural persons starting a venture and the third parties that engage with it.

Young companies will find it hard to find external financing as there is no guarantee that the market failures intrinsic to start-ups will not occur. That task has to be left to the private and public institutions specialised in the provision of seed and growth capital.

In considering the financing issues facing start-ups, it is important to view them through the prism of the investments needed to fund a new venture. To do that, the overall technological and innovation ecosystem needs to be looked at.

We agree that a revision of the headcount and/or revenue thresholds that may create external costs of growth for enterprises is in order but believe that any such initiative needs to establish that the adverse effects of those costs on societal wellbeing are higher than the potential benefits sought by the legislator when those thresholds were first established.

In our opinion, the impact of the external costs of growth generated by the public policies tied to company size on the make-up of the Spanish business sector and its productivity is overestimated. What public business creation policy overlooks completely are the internal costs of growth. As a first step in taking them into consideration, we recommend that the government commission a white book on management practices in Spain.

Notes

[1] To demonstrate that those costs and the associated barriers exist, some have studied the discontinuity in the distribution of company sizes around those thresholds, specifically an over-concentration of companies with between 40 and 45 employees and just below 6 million euros of revenue and an under-concentration in companies with between 50 and 55 employees and just over six million euros in revenue (Almunia and López-Rodríguez, 2014). The leap to the next conclusion is straightforward:

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eliminating the thresholds, the external costs of growth would decrease and company size and productivity would increase.

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