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EDITORIAL

A SME Strategy for France

Report by Jean-Paul Betbèze and Christian Saint-Étienne

France is currently seeing a significant acceleration in new business creation and is the home of some highly competitive global firms – so what is there to complain about?

The problem is that France is lacking the very fast-growing small to medium-size enterprises (SMEs), known as 'gazelles'. We have no equivalent of Germany's middlestand and we are very far behind. This report begins with this rather disturbing observation and shows just how much is at stake. With a denser population of medium-size companies, France's GDP growth, employment, competitiveness and investor appeal would be much stronger. The R&D situation would also be vastly improved.

The report presents a programme of economic policy measures, some of which the government has already said it would support. Promoting the development of small businesses and the formation of a French 'middlestand' will require a full array of complementary measures and not just one or two miracle solutions.

Christian de Boissieu
Executive Chairman of the CAE

Gazelles are the 2,000 or so French SMEs (of a total of 1.2 million) that grow two to three times faster than the average SME and account for over half of net SME job creation. French gazelles are a third less profitable than their foreign counterparts, particularly in the UK and the US, due to various structural obstacles that are specific to the French economy. This means that they generally reach their maximum size earlier, and are smaller and fewer in number than their foreign peers. To leverage their economic potential more effectively, the report recommends removing or reducing some of the rigidities that are characteristic of the French market and implementing measures specifically aimed at SMEs.

In the spring of 2006 the authors presented their report to Thierry Breton, the minister of the Economy, Finance and Industry, and to Renaud Dutreil, the minister in charge of SMEs, Commerce and Independent Professionals, in consultation with the prime minister.

This Letter, published by the Permanent Committee, summarizes the authors' main conclusions.

France does not have enough middle-size companies, i.e. having from 50 to 500 employees, which explains why it also does not have enough 'mini-groups' employing between 500 and 3,000 people. The companies that we are lacking in particular are the 'gazelles'. This observation is the starting point from which Jean-Paul Betbèze and Christian Saint-Étienne have developed their strategic plan, which makes promoting the growth of these mid-size companies a key objective of economic policy. This involves not only facilitating business creation, but above all removing the obstacles that prevent these companies from developing.

For the purpose of their report the authors have divided companies, which account for the bulk of GDP in most developed economies, into three categories: elephants, gazelles and mice. Elephants are the largest companies or groups. Over the long term they tend to destroy jobs as they outsource and streamline their

activities, although they do continue to grow through acquisitions. Mice are very small companies with 0 to 20 employees, that do not grow and which, due to the nature of their business and market positioning, do not create many jobs. They do however play a key role in the economy by ensuring the local provision of products and services. Gazelles are the fastest growing of the SMEs, which have 20 to 500 employees, or from 20 to 250 under a narrower definition. The gazelles studied in the report are companies that from 1993 to 2003 either grew two to three times faster than the other SMEs in their sector of activity, or were within the top 5 or 10% of the total SME population in terms of sales or workforce growth, or had annual sales growth above either 10 or 20% for at least four years. The report begins by presenting an assessment of the current situation and then recommends a strategic plan to promote the growth of these gazelles.

The current situation

SMEs with less than 500 employees account for over half of the value added produced in France. They employ 60% of all employees and 65% of all people working in the private sector and have driven the bulk of job growth over the past 15 years. While large companies belonging to groups have destroyed some 263,000 jobs between 1985 and 2000, firms with less than 500 employees have created almost 1.8 million. And yet SMEs in France are often misunderstood, unknown and burdened with excessive charges and constraints. They are lumped together and dealt with by the government in a standardized manner, although they tend to be quite different in terms of their business activities, size and above all potential. The report focuses on what will be necessary to enable these firms to grow.

Gazelles play a key role in employment

According to a study conducted by Claude Picart of INSEE, France's national statistics bureau, gazelles created 582,000 jobs from 1993 to 2003, of the total 1,115,00 jobs created by SMES during this period, or about 52%. Of the 404,000 surviving companies, the 5% that grew the fastest created 1.43 million jobs during these ten years, which is more than the 167,000 other SMEs that expanded their workforce. The gazelles show a much higher annual job creation rate than the other surviving SMEs –18% vs. 7%. Their growth tends to be highly concentrated over a short period of time and they double in size during their fastest-growing year. Even when the economy is sluggish they still grow robustly, both organically by innovating and through acquisitions. Gazelles tend to be born when larger groups restructure their operations and to be particularly prevalent in the business services sector. Among the 47,000 gazelles still in business at the end of the 10-year period, 51% were subsidiaries of a group. Of the fastest-growing top 5% of these 47,000 companies, 78% belonged to a group. According

to a more detailed study covering the period from 1998 to 2001, much of this growth may be attributed to intragroup restructuring. However, many of these groups are relatively small and their gazelles represent over half of their total workforce. These account for almost half of the jobs created by all gazelles.

Gazelles have insufficient support although they make a decisive contribution to productivity. According to the authors, surviving companies account for the major part of productivity growth. Regardless of country or industry, the productive gains they achieve systematically account for at least half of total productivity gains and often up to 70-90%. The main macroeconomic impact of the emergence of new and young companies is not so much the direct result of their more efficient use of capital and labour but rather their stimulating effect on the other incumbent firms, which can only survive by copying the newcomers' innovations or by innovating themselves. The ability of these companies to continue to develop and survive is a perfect illustration of Joseph Schumpeter's model of «creative destruction» over the long term.

In France, large companies account for a very high proportion of private-sector research and development. The 13 largest French groups conduct half of all corporate R&D. French firms with less than 500 employees, and which employ 65% of all employees in the private sector, account for less than 15% of private R&D. France's lag in private research can mainly be attributed to the fact that companies with 50 to 500 employees are weak in R&D. These French SMEs spend half as much of their annual sales on R&D as their US counterparts. Any public policy to favour innovation must aim to increase the innovation capacity of existing companies as least as much as it supports new companies.

French companies not profitable enough

A study by the Bank of France shows that from 1997 to 2002 the profitability of French companies

was 76% of the weighted average profitability of German, US and UK firms, and 61% of the weighted average profitability of German and UK firms alone. According to the authors this discrepancy has nothing to do with French entrepreneurs being more averse to risk-taking, or over-expensive and restrictive lending by banks. French SMEs, for example, are not significantly less inclined to hire than their foreign counterparts. Nor are interest rates a handicap for French SMEs, since interest rate spreads vary little according to the size of the loan or borrower. The authors believe that this lower profitability is the consequence of France's social security charges which are much higher than in the three other countries, longer settlement periods and a more rigid labour market. This means that French companies do business in a more difficult social and regulatory environment. Excessively long settlement periods seem to have much to do with this situation. French firms had cumulative outstanding trade receivables totalling 380 billion euros in 2004. The French public sector is particularly slow in paying for its products and services, taking an average of 68.7 days and often long after the agreed payment date.

Although the French economic model prevents companies less inclined to take risks from growing as fast as they could, it tends more importantly to penalise firms that take on or would like to take on more risk, in other words gazelles that want to run faster and assume more debt. It is not so much that banks refuse to lend, but rather that their lending tends to be «capped» right from the start by a general incapacity to deal effectively with more ambitious entrepreneurs and especially the gazelles, which are willing to take more risks and need more credit and are therefore likely to be charged much higher interest rates. The UK and US credit spreads of 700 to 800 basis points for short-term loans and 200 bps for medium- and long-term loans are contrary to French financial, business and social practices. Enabling gazelles to

run faster means accepting the fact that they must pay higher interest rates due to the greater risks involved, which requires appropriate guarantees. By shortening the time horizon of entrepreneurs, the French financial system tends to favour asset-based business models as opposed to entrepreneurship.

Difficulty in adapting to major organisational or generational change

According to the authors, young gazelles often cannot become nimble elephants because their profitability is a third less than that of their competitors in the United States, Germany or the UK. This is not because they are less efficient but is the consequence of a greater tax burden (including corporate, wealth and personal income taxes), higher expenses in general (particularly organisational) and less effective financial markets. As a result, the optimum size of French gazelles tends to be smaller, since their comparative return on investment in relation to risk discourages their development. The difficulty that French gazelles have in making the major organisational changes necessary to accommodate their growth tends to cause French entrepreneurs and parent companies to disinvest at an earlier point than their foreign counterparts. The strategic horizon of the CEO of a French SME is indeed shorter and growth objectives are accordingly less ambitious. The owner of a French gazelle will tend to sell his or her interest to a larger company or to a private-equity fund to «lock-in» a profit and reuse capital that is once again liquid. This would not necessarily be a problem if this capital were reinvested in France, however, the ISF wealth tax encourages much of this wealth to move abroad.

Action plan

On the basis of this assessment, the authors recommend an action plan that must profoundly change current practices if it is to have any real impact. It involves not only stimulating entrepreneurial drive to develop fast-growing

SMES but also creating an environment that will enable potential French gazelles to keep on running.

A coherent plan

The proposed plan seeks to increase the after-tax profitability of productive activity in France, and in particular that of firms that employ fewer than 500 employees in France. To achieve this overall objective the report proposes that the government focus most of its efforts on increasing the number of fast-growing SMEs and gazelles in particular. Since over 99% of these are unlisted and family-owned, a coherent plan is required to support these firms while encouraging family capitalism. The plan's has four main objectives.

Accelerating SME growth

This recommendation aims to increase the quality of business creation by reducing the high mortality rate of young companies. A particular emphasis is placed on assisting the most promising entrepreneurs. The recommended measures aim to facilitate the birth of new companies and reduce their administrative expenses, most notably by creating a «one-stop shop» that SMES can turn to for assistance with all of their administrative and tax questions. The system of hiring subsidies and allowances must also be harmonised and simplified. The authors recommend making SMEs with less than 250 employees the first in France to enjoy the benefits of «flexisecurity», under a negotiated agreement between employers and trade unions. The objective is to base job security on people and not on the jobs themselves,

through more effective training and higher unemployment benefits provided that employment is actively sought.

Restoring profitability

Increasingly long settlement periods and the increase in the number of defaults are one of the main reasons why many SMEs go out of business or are insufficiently profitable. The first measure proposed is to speed up payments made by the public sector, large corporations and large retailers. According to the authors, if the government paid its SME suppliers as rapidly as do private-sector customers this would increase SME net income by 2%. This would increase public debt by 25 billion euros, but it would be a once-and-for-all transaction and would greatly increase debt transparency. In 2006, the ratio of public debt to GDP, which is currently estimated at 66.1%, is expected to rise to 67.5%. The second measure recommended is a corporate tax rate of 18% on the first one million euros of taxable earnings, capped at 5% of annual sales, with €100,000 of earnings taxed at 18% regardless of revenue. The third measure is to make financial aid digressive to avoid «threshold effects». The fourth and last measure that the authors propose is to improve the French government's plan to promote the creation of Small Business Investment Companies (SBIC) that would either lend to or invest in growing firms. Their recommendation is that these investment companies first guarantee the government a fixed rate of return and then distribute any capital gains after interest expenses, in a way that would favour shareholders. Average share ownership would be about five million euros.

Opening up and stabilising financial markets

The first group of measures seeks to promote innovation in SMEs, since current measures to support R&D almost exclusively favour

the largest corporations. One of these measures is to harmonise existing private-sector research networks, of which there are currently at least seven distinct types. Research tax credits could also be used to increase SME spending on R&D, by allowing them a higher credit rate. The aim of the second group of measures is to facilitate SME access to export markets and public sector contracts. The authors recommend the creation of a French «Small Business Administration» whose role would be to make sure that SMEs are well informed of public sector procedures, tendering rules and measures to support research and innovation and to reduce or facilitate the financing of patent expenses for start-ups. A specific percentage of government contracts could also be allocated to European SMEs.

Supporting «fast-track» growth

This involves three types of actions. The first consists in smoothing out the growth process and the necessary adaptations by stabilizing the legal and fiscal frameworks and reducing the number and complexity of the procedures involved. The second is to promote and support the training of SME managers and executives in specific sectors while enhancing the perception of the entrepreneur's role. The report also recommends replacing the ISF (wealth tax) with a 4% «wealth income tax» (IRF), to strengthen SME finances and simplify the tax issues that may arise when a company is sold. The government's recent creation of a «tax shield» is a rather complex mechanism that fails to change the perception of ISF as «punishment» for the accumulation of wealth and thus hinders wealth creation. An IRF tax would be both

economically more efficient and easier to apply.

Employee share-ownership should also be encouraged, as should SME access to financial markets. Alternext, which is not a regulated market but offers simplified listing requirements for securities issuers and some protection for investors, provides new financing opportunities for SMEs. Its development will require close monitoring.

Comment

Philippe Trainar takes issue with the report's recommendation of a progressive corporate income tax. In his opinion, a progressive tax on business entities cannot be justified from either an economic or a moral standpoint, as it can in the case of households. Any such measure should therefore only be temporary, either as an initial step toward a general decrease in corporate income tax, or until more structural measures have time to take effect. Regarding the financing of gazelles, Philippe Trainar agrees with the idea that a SBIC should be more than just a means of indiscriminately injecting more liquidity into the market. On the other hand, he has some reservations regarding the recommendation to finance a SBIC in part through a 4% loan from the government or the CDC. In his opinion, the report should place much more emphasis on the highly strategic role that another and if possible European stock exchange for smaller companies could play in financing both the creation and growth of French gazelles and on the need to closely monitor Alternext, which has yet to prove itself.