BARRIERS TO EXIT:

An overview of recent work by the OECD Economics Department

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Introduction and outline

- Disclaimer on the general approach: economy-wide rather than sector-specific
- Defining and measuring “zombie firm” prevalence
- Economic consequences of the lack of restructuring
- Relevant policies to enable exit and reallocation
  - Insolvency regimes
  - Financial sector health
  - Policies to support efficient reallocation

Defining a zombie firm: two main approaches

There is no unique definition of zombie firms (e.g. impossible to reflect all country/industry specificities, fundamental questions about future demand and prices)

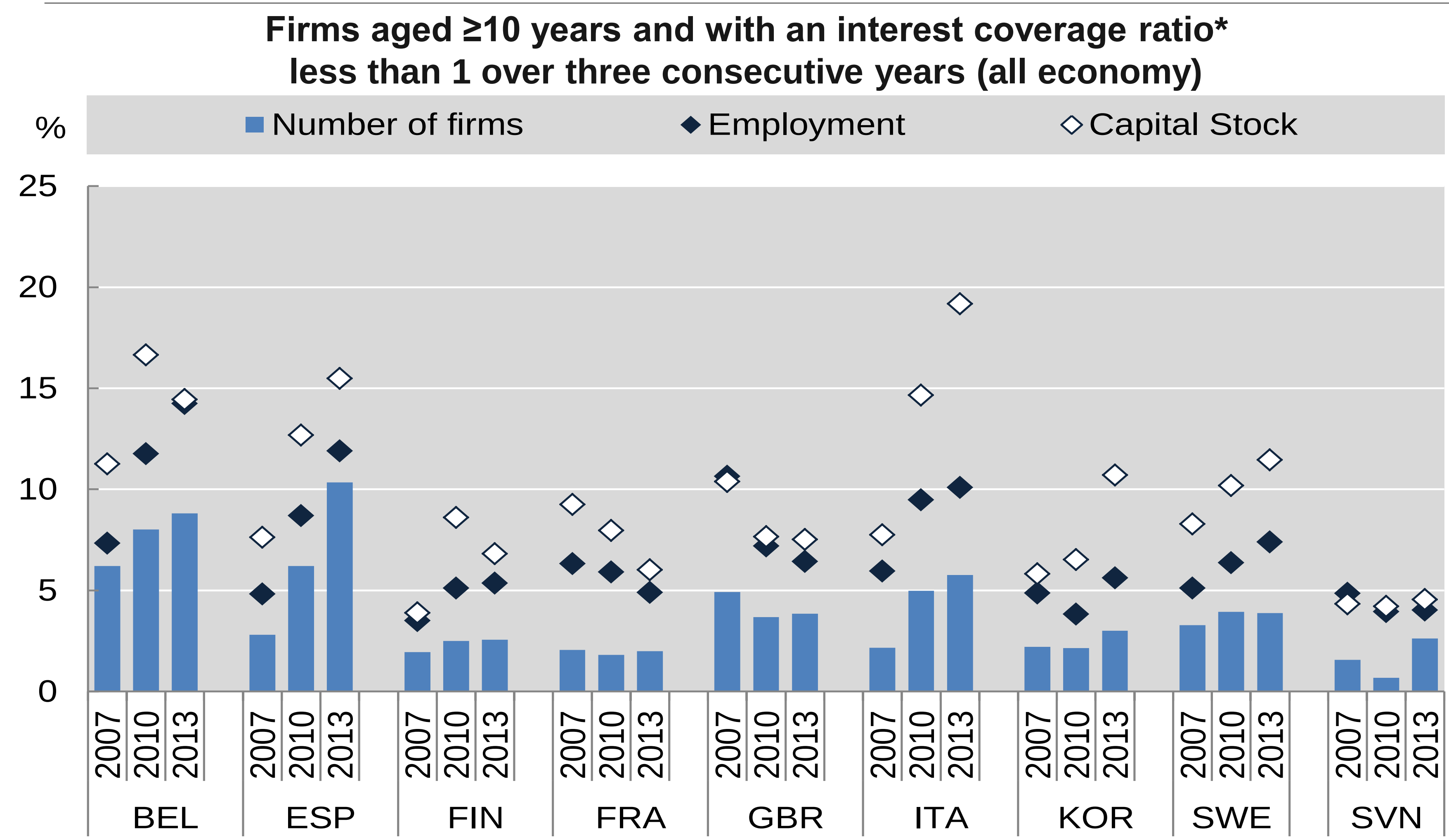
In our empirical analysis, zombie firms are defined as incumbent firms (older than 10 years) that display persistent financial weakness on 2 alternate metrics:

1. ICR approach: Interest Coverage Ratio (i.e. EBIT/Interest Payments)<1 for 3 consecutive years

2. NRI approach: Low debt service capacity (EBIT/Debt<0.2) and either Return On Assets<0 or Net Investment<0 for 3 consecutive years

The results are similar with both definitions.

The share of zombie firms has increased in a number of countries



Interest coverage ratio = (EBIT/Interest Payments)

Source: Adalet McGowan, M., D. Andrews and V. Millot (2017), “The Walking Dead? Zombie Firms and Productivity Performance in OECD countries”, OECD Economics Department Working Paper No 1372.

The share of zombie firms seems higher than average in the steel sector

The share of zombie firms in total capital is about 10% in the average country in our sample (subgroup of OECD countries).

In the “manufacture of basic metals” industry (the closest measure to steel sector), it is about 20%

These are orders of magnitude that should be interpreted with caution (data coverage is not perfect)

Why do zombie firms matter for overall economic performance?

Delaying their exit or restructuring:

1. Drags down average (unweighted) productivity
2. Stifles reallocation: by consuming scarce resources they congest markets, undermining growth opportunities for healthier firms (in the same industry and others)
3. Deters entry of potentially innovative young firms

Empirical analysis shows that when more capital is sunk in zombie firms:

1. The typical healthy firm invests less
2. Particularly so young and more productive firms, which hurts overall productivity

Insolvency regimes matter for the efficiency of restructuring

Insolvency regimes are crucial for firm exit and restructuring since they can bring debtors and creditors to the table to deal with financial distress in a timely an orderly fashion.

We have compiled a new OECD cross-country indicator on the key design features of insolvency regimes that impact the timely initiation and resolution of proceedings

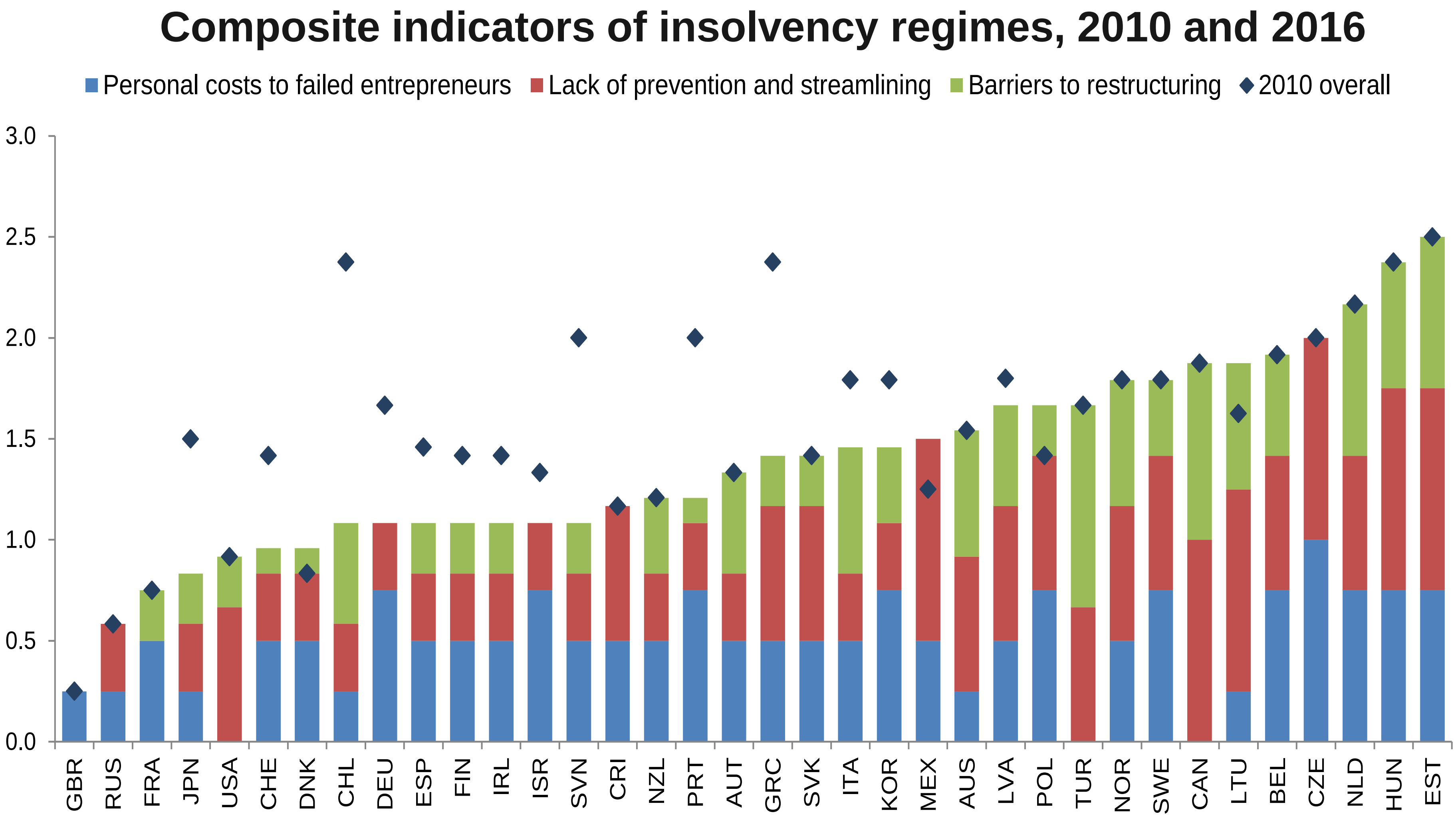
Empirical analysis shows that improving insolvency regimes can reduce zombie firm incidence and increase productivity (both through efficient reallocation and within-firm)

New OECD indicator on the quality of insolvency regimes

Aggregate insolvency indicator (Insol-13)

A. Treatment of failed entrepreneurs	B. Prevention and streamlining	C. Restructuring tools	D. Other factors
1. Time to discharge	3. Early warning mechanisms	6. Creditor ability to initiate restructuring	11. Degree of court involvement
2. Exemptions	4. Pre-insolvency regimes	7. Availability and length of stay on assets	12. Distinction between honest and fraudulent bankrupts
	5. Special insolvency procedures for SMEs	8. Possibility and priority of new financing	13. Rights of employees*
		9. Possibility to "cram-down" on dissenting creditors	
		10. Treatment of management during restructuring	

The design of insolvency regimes varies widely across countries



Note: Higher values indicates higher barriers to restructuring

Financial sector health also matters

Bank forbearance: weak banks continue to support – and bet on the resurrection – of zombie firms to avoid the realisation of losses on their balance sheets (e.g. Japan in the 1990s).

Empirical analysis shows that weak banks are more likely to lend to zombie firms

One potential consequence is credit crowd-out: banks direct less credit to healthy firms than otherwise

→ Ensuring that the banking sector is healthy (resolving non-performing loans) and favouring the development of other sources of finance (e.g. reducing the bias to debt financing in corporate tax systems) can support efficient restructuring and productivity

A range of other policies is relevant to support efficient reallocation

Recent OECD research (Andrews and Saia, 2017) has shown that active labour market policies (ALMPs) can aid the re-employment prospects of displaced workers

The effectiveness of ALMPs is also enhanced by lower entry barriers in product markets and higher public sector efficiency.

Reductions in the labour tax wedge can aid the reemployment prospects of displaced workers.

Finally, regional mobility is a key channel through which workers who lose their job due to plant closure become re-employed, suggesting that housing market policies may also be relevant.

Thank you for your attention

All underlying material (papers, presentations, details of the insolvency indicator) can be found on this dedicated website:

http://www.oecd.org/eco/growth/exit-policies-and-productivity-growth.htm