

Europe and Central Asia Economic Update
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Competition and Firm Recovery Post-COVID-19

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Why focus on competition?

This ECA Economic Update assesses the impact of COVID-19 on firms in the region, with a focus on the role of competition during the crisis and recovery.

Competition is key to sustainable, long-term economic growth and associated with greater dynamism. It contributes to growth by:

- incentivizing firms to innovate and become more efficient (*productive efficiency*)
- shifting resources towards more efficient firms (*allocative efficiency*)
- forcing less efficient firms to exit, more efficient ones to grow, and new ones to enter (*market contestability/creative destruction*)

COVID-19 has heightened concerns about limited competition – if smaller firms find it more difficult to adapt/receive less government support and thus are more likely to exit, concentration and dominance of large firms may increase and further limit competition, just when it is most needed to promote recovery.

As ECA starts to recover from the COVID-19 crisis, it will be important to ensure that a competitive business environment is in place for jump-starting growth.

This ECA Economic Update

- I. Illustrates the competition landscape in ECA pre-COVID-19
- II. Explores impact of COVID-19 on firms, including in different competition environments
 - How did COVID-19 affect firms' growth, employment, technological adaptation?
 - Did the impact vary by firm characteristics (size, age, sector, gender of top manager)?
 - Is there any evidence creative destruction so far, with resources allocated to firms that are more productive?
 - How did the competition environment influence this reallocation?
- III. Describes government support initiatives and identifies which firms received them
- IV. Concludes with policy recommendations for competition and recovery

I. Pre-COVID-19 Competition Environment in ECA

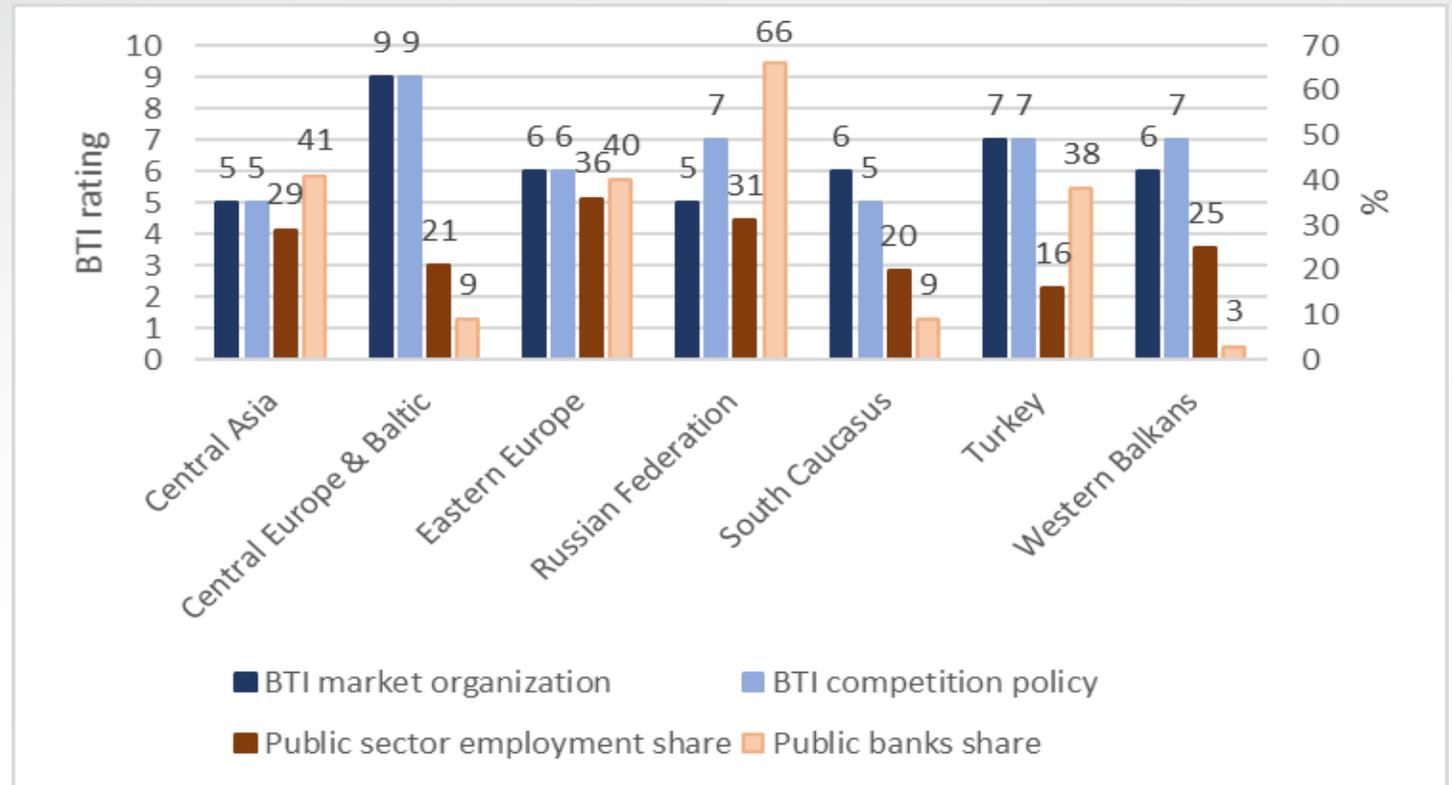
The competition environment is characterized by four measures.

- First two come from the 2020 Bertelsmann Stiftung Transformation Index (BTI), which surveys political and economic transformation around the world based on expert opinion. Two subcomponents of provide information on the competition environment:
 - BTI market organization
 - BTI competition policy
- The next two measures that may be associated with the level of competition are proxies for the size and share of public sector:
 - Share of public sector employees in total employment
 - Share of public banks in total banking sector assets

I. Pre-COVID-19 Competition Environment in ECA

- The average score for ECA is 7 for both BTI competition measures (1-10). Room for improvement in many subregions/countries.
- Average public sector employment share is 24% and 18% for public banks share, with large variation across countries.

Average competition ratings and proxies, by subregion

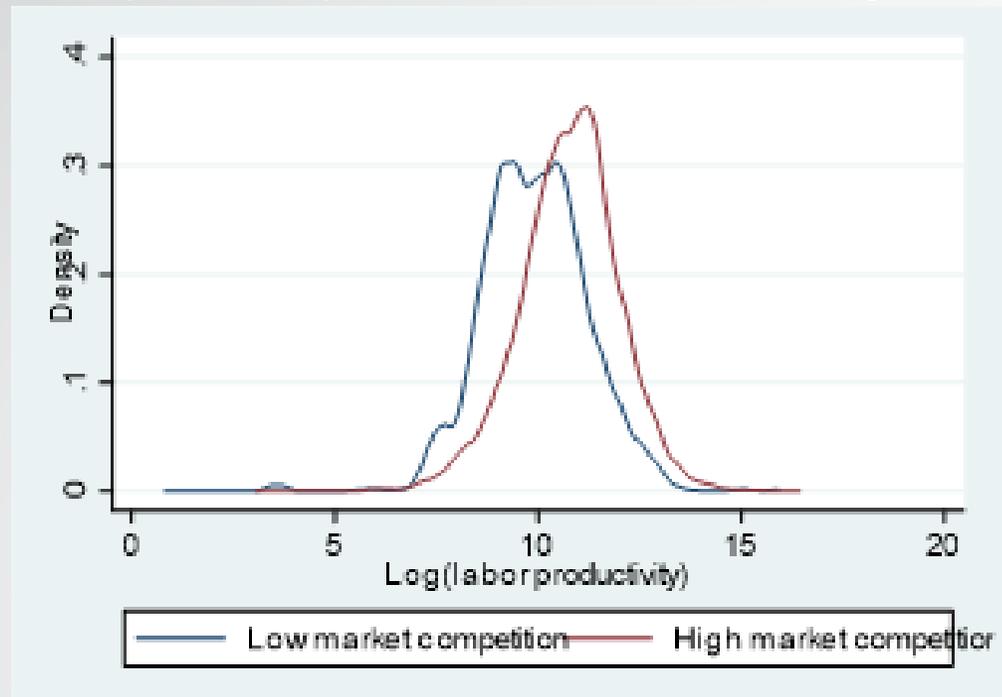


Source: Bertelsmann Stiftung foundation

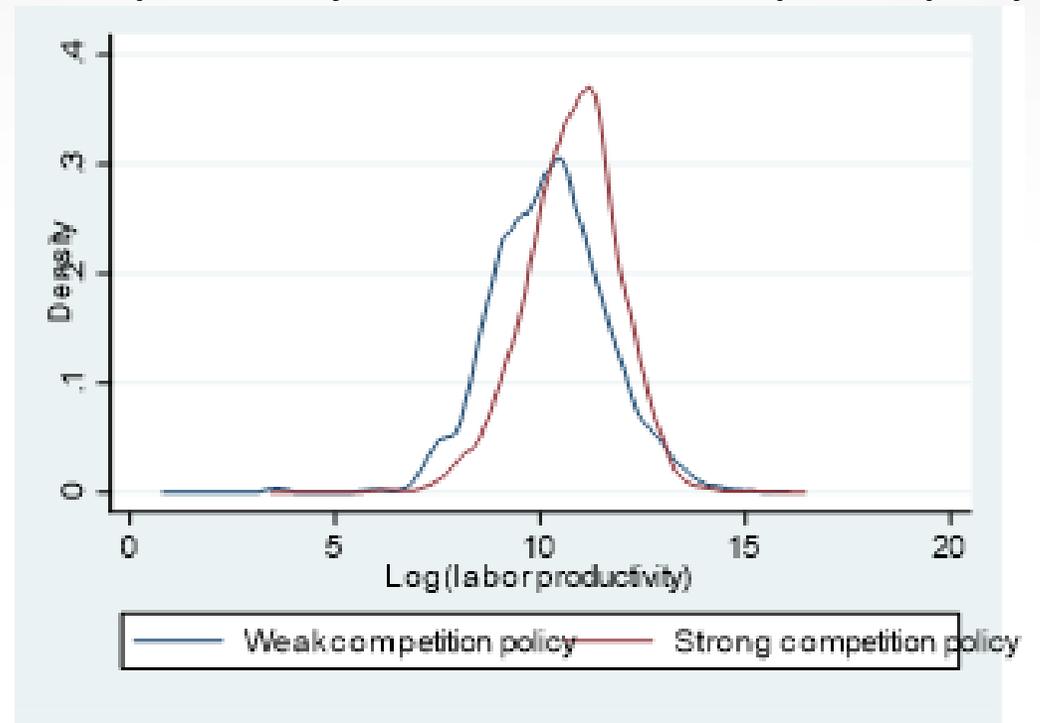
Pre-COVID-19 competition and labor productivity

In countries with a more competitive environment, firms had higher pre-crisis labor productivity, as measured by sales per worker in 2019 across countries in ECA.

Labor productivity distribution for BTI market organization



Labor productivity distribution for BTI competition policy



II. Impact of COVID-19 on Firms

Analysis based on data from the World Bank's Enterprise Surveys (ES) COVID-19 Follow-up Surveys for 23 countries in ECA

- Asks about firms' changes in performance compared to a year ago or since the start of the COVID-19 pandemic.
 - Round 1: conducted between May and November 2020
 - Round 2: conducted between November 2020 and May 2021
- Can be linked with most recent pre-COVID-19 ES (typically conducted in 2019 for ECA) for rich set of firm characteristics, including productivity

Impact on sales

- Firms in the region faced sustained revenue losses during the pandemic, although the average drop in sales was smaller compared to other regions.
 - Round 1: ECA firms reported an average drop of 24% in monthly sales to one year earlier
 - Round 2: ECA firms reported an average drop of 23% in monthly sales to one year earlier

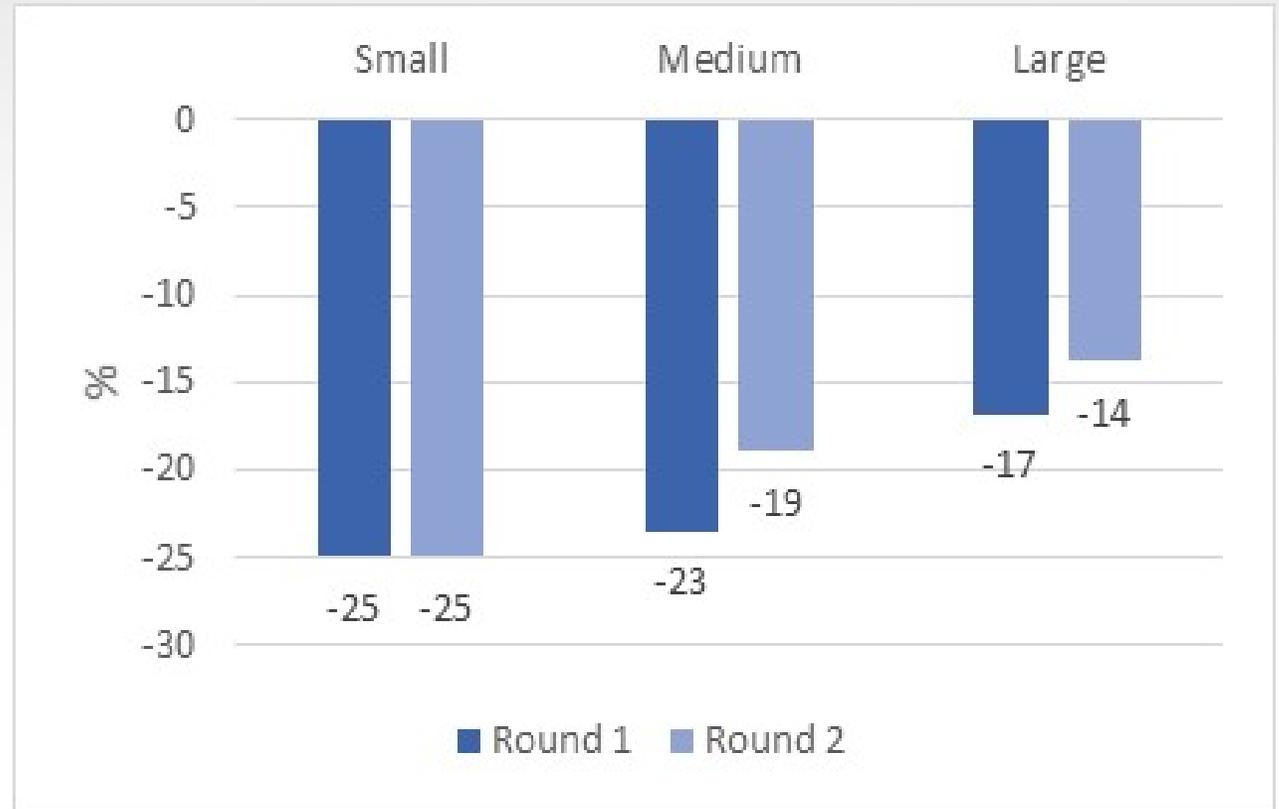
... and impact on employment, digital adoption, exit

- The decline in the number of permanent full-time workers of ECA firms was more muted than the drop in sales (also observed globally).
 - Round 1: ECA firms reported an average drop of 10% since December 2019
 - Round 2: ECA firms reported an average drop of 13% since December 2019
 - Firms adjusted their workforce proportionately less since they relied on other mechanisms (granting leave, reducing hours, lowering wages, benefiting from wage subsidies)
- Digital adoption: to respond to the crisis, 29% of firms started or increased online business activity, and 36% started or increased remote working arrangements.
 - These show initiative to adapt to changes, but may have had limited impact in weathering the crisis, since average percentage of online sales was 8% and average share of remote work was 7%
- Firm exit rates in ECA were low (average of 1.9% compared to 6.2% globally)
 - However, firms reported serious financial distress; by round 2, 26% of firms reported anticipating arrears on outstanding liabilities in the next 6 months

Smaller firms hit harder than larger firms

- Small firms experienced larger drops in sales and employment.
- However, small firms were less likely to reduce their workforce than large firms.
- Small firms also face greater difficulties in recovering as more expected to fall into arrears on outstanding liabilities compared to large firms

Change in monthly sales compared with one year ago, by firm size



Impact across sectors varied

- The services sector experienced higher drops in sales and employment. These could be due to the lockdowns and travel restrictions imposed during the pandemic.
- While sales recovered in the manufacturing and services sectors, sales dropped in the retail sector between rounds.
- Firms in all sectors had similar expectations of falling into arrears.

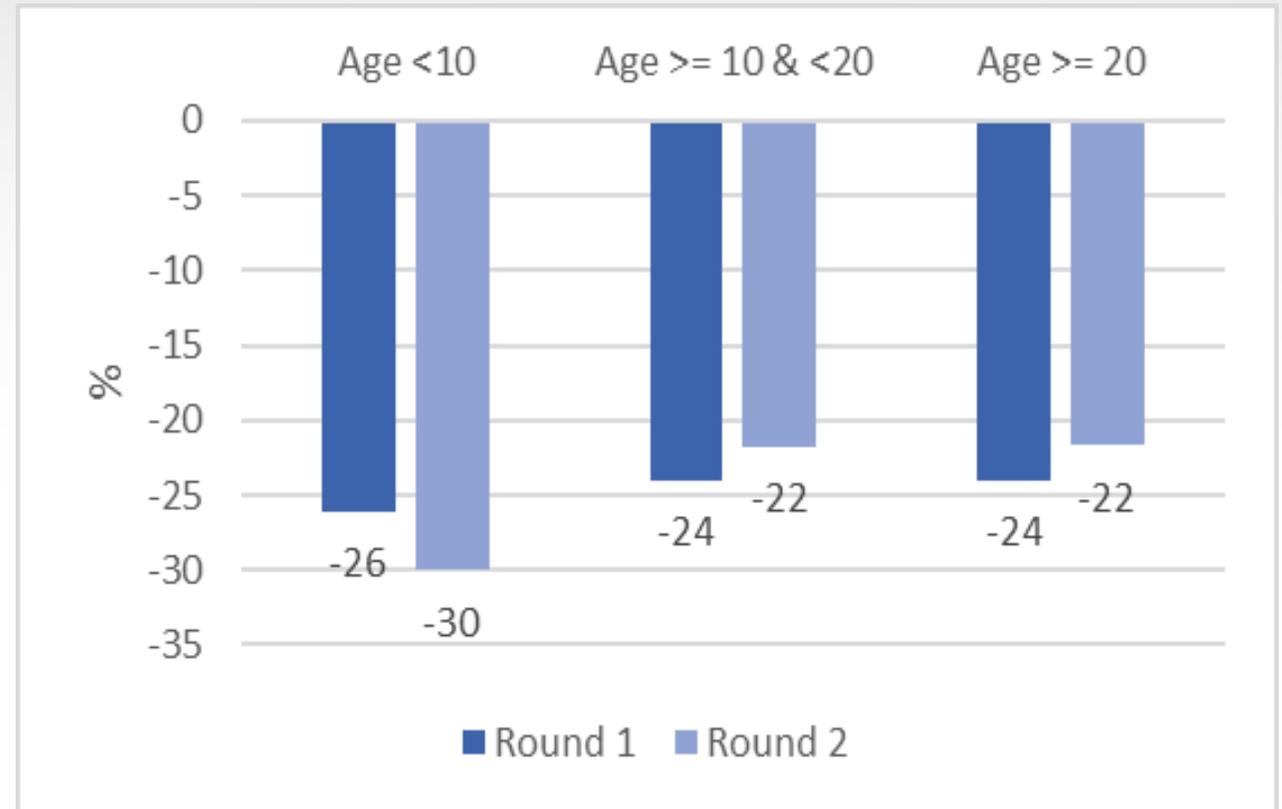
Change in monthly sales compared with one year ago, by sector



Youngest firms affected the most

- Youngest firms experienced the largest drops in sales and employment.
- They are also most likely to expect falling into arrears.
- On the other hand, to mitigate these losses and adapt to the new normal, the youngest firms started or increased online business activity the most.

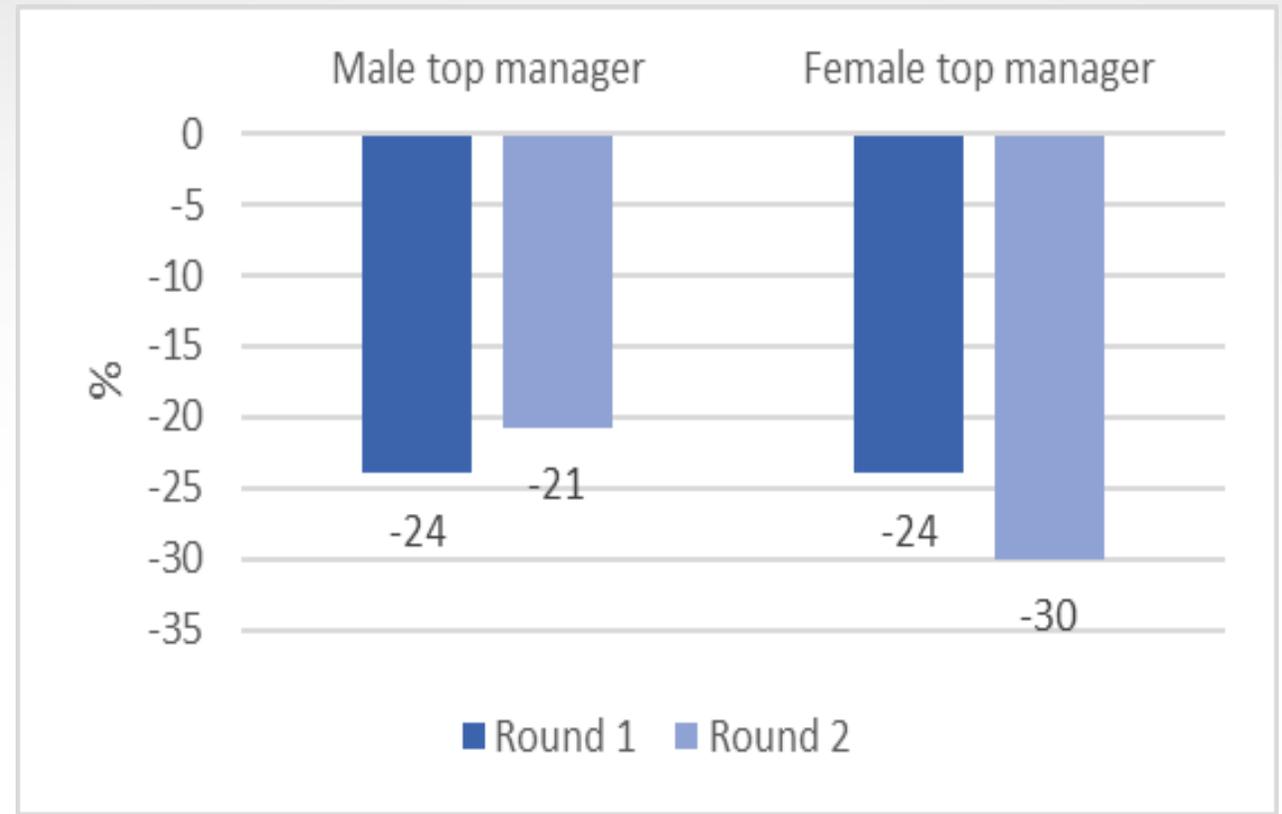
Change in monthly sales compared with one year ago, by firm age



Female-run firms had greater difficulty recovering

- Despite similar initial drops in sales, firms with female top managers experienced further losses while firms with male top managers recovered in round 2.
- Female-run businesses also had higher drops in employment.
- They were also slightly more likely to anticipate falling into arrears compared to male-run businesses.

Change in monthly sales compared with one year ago, by gender of top manager



Is there any evidence creative destruction so far, with resources allocated to firms that are more productive?

- **Yes.** Regression analysis shows that firms with high pre-crisis labor productivity experienced smaller drops in sales and employment than firms with low pre-crisis labor productivity.
- More productive firms were also more likely to adapt to the crisis by increasing online activity and remote work.
- The magnitudes of these effects reveal that, compared to firms in the *90th percentile*, those in the *10th percentile of the pre-crisis labor productivity distribution*:
 - Experienced a **12-percentage point larger drop in sales**;
 - Experienced a **9-percentage point larger drop in employment**;
 - Were **14 percentage points less likely to have increased remote work**;
 - Were **11 percentage points more likely to anticipate falling into arrears**.

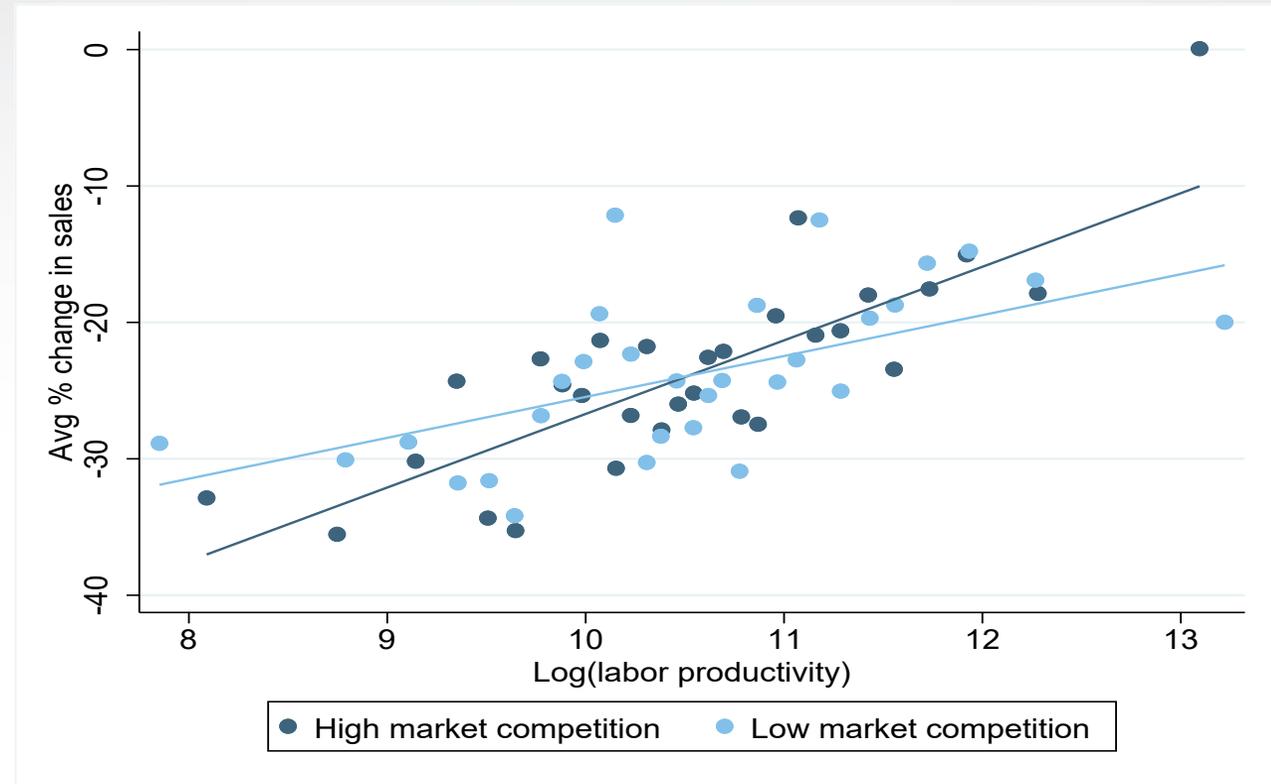
What about the role of competition?

- The analysis shows that in ECA countries with more competitive markets and stronger policies that protect competition, there was more reallocation of economic activity from less productive to more productive firms.
- Similarly, in countries with a larger share of public employment in the public sector and a higher public ownership of banks, the reallocation from lower productivity to higher productivity firms was weaker consistent with lower competition and dynamism associated with a greater role of state.

The reallocation to more productive firms is stronger in higher competition environments

- For example, in countries with high competition, the relationship between labor productivity and firm sales during the crisis is steeper than in countries with low competition.
- In countries with high competition, Compared to firms in the *90th percentile*, those in the *10th percentile of the pre-crisis labor productivity distribution*:
 - Experienced a **17-percentage point larger drop in sales**; compared to a difference of 10 percentage drop in low competition countries.
- The relationship of labor productivity and employment, falling into arrears, and technological innovation are similarly stronger in countries with more competitive environments.

Percentage change in monthly sales compared with one year ago



Consistent results exploring firm exit rates

- Although confirmed exit rates in ECA were low during the COVID-19 crisis (annualized 1.9 percent on average), analysis by Muzi and others (2021) suggests that less productive firms were more likely to exit during the crisis.
- Whether the reallocation of economic activity toward more productive firms is long-lasting will depend on whether more productive firms grow and less productive firms ultimately exit.
- To facilitate faster firm exit and further job creation for productive firms, strengthening the competition environment and regulation is key.

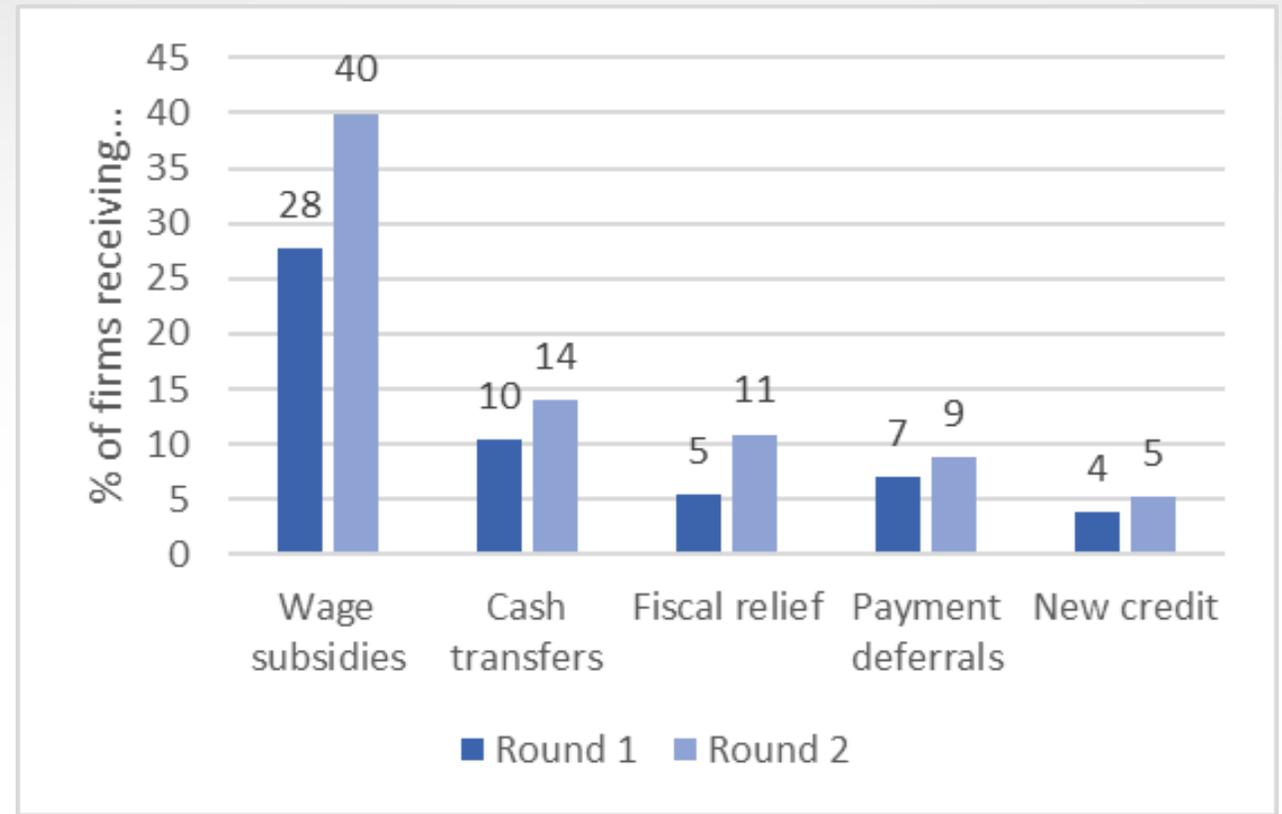
III. Government Support Measures

- In response to the economic impact of the pandemic, governments around the world provided support to both households and firms. Support to firms was provided in order to prevent mass insolvency and bankruptcy of viable firms facing financial distress and related knock-on effects for the financial sector, to prevent losses of jobs and firm-specific intangible capital, and to reduce the friction costs of firms temporarily exiting the market (World Bank 2021c).
- According to the World Bank's SME Support Dashboard, countries in ECA enacted more than 430 measures to support SMEs in response to COVID-19
- The five most common measures were credit (26 percent), fiscal relief (20 percent), wage subsidies (17 percent), payment deferrals (12 percent), and cash grants (7 percent).

Reach of government support in ECA

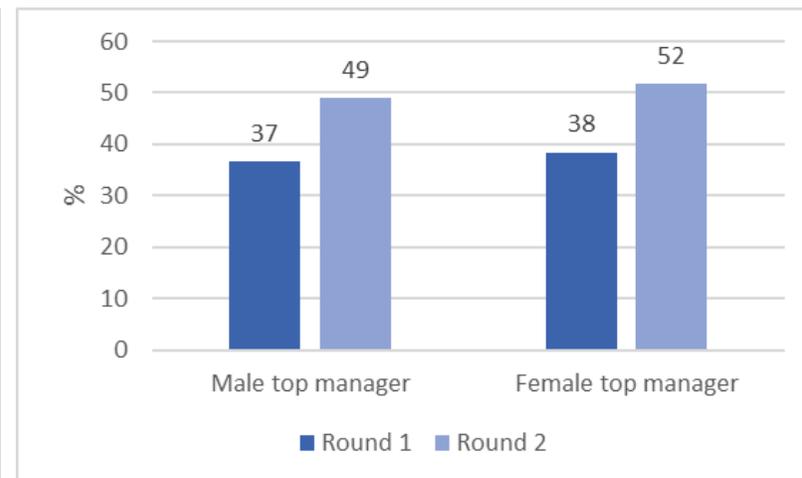
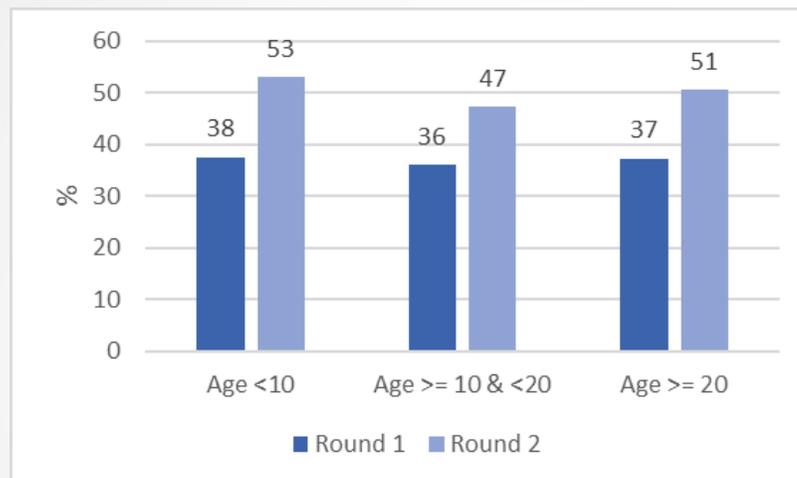
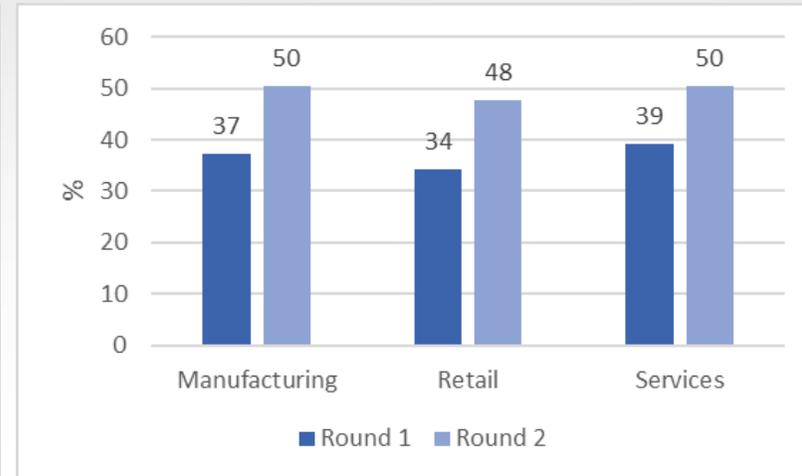
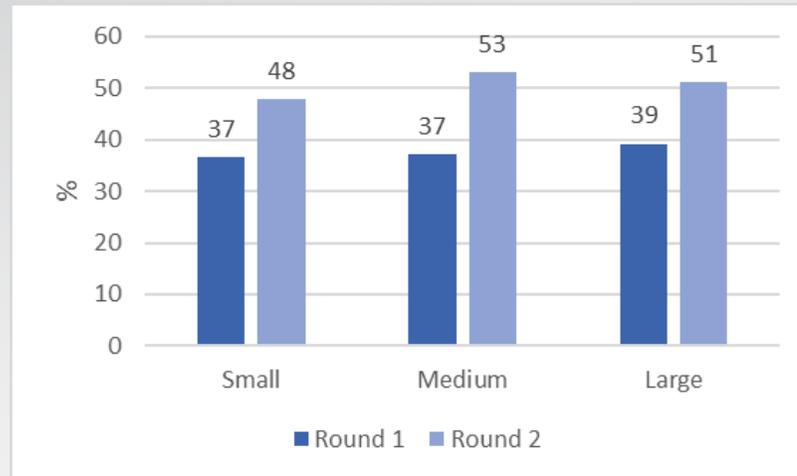
- In ECA, wage subsidies was the most widely received support reported by firms, reaching 40% of firms by round 2.
- Although new credit was the most common measure according to the SME-Support Measure Dashboard, it reached only 5 percent of firms.
- By round 2, **50% of firms in ECA reported to have received government support.**

Government support measures in Europe and Central Asia, by type



A cursory look suggests support allocation did not vary much across firm types ...

Percentage of firms in Europe and Central Asia that reported receiving government assistance, by firm size, sector, age, and gender of top manager



... but a more careful look reveals the following patterns

Regression analysis shows that:

- More productive firms were less likely to receive any type of government support. Firms in the *10th percentile of the pre-crisis labor productivity distribution* were **6 percentage points more likely to receive government support** than firms in the *90th percentile*.
- Larger firms were more likely than smaller firms to receive payment deferrals and fiscal relief.
- Firms with a female top manager were **5 percentage points more likely to receive government support** than firms with a male top manager.
- Pre-crisis innovation is not correlated with receiving any type of government support.

IV. Conclusions and Policy Recommendations

- Overall, the findings suggest that the COVID-19 crisis had a profound and heterogenous impact on firms.
- A competitive business environment is key for sustainable, long-term economic growth:
 - Before the pandemic, firm's labor productivity was higher in countries with more competitive environments
 - During the crisis, economic activity appears to have been reallocated towards more productive firms, especially in countries with more competitive markets
 - More productive firms were also more likely to adapt to the crisis by increasing online activity and remote work
 - Whether this reallocation is long-lasting will depend on whether more productive firms grow and less productive ones ultimately exit; which again depends on the competition environment
- Importantly, the results also show that—whether intentionally or not—the broad COVID-19 support governments provided disproportionately went to less productive firms, irrespective of pre-crisis innovation.

IV. Conclusions and Policy Recommendations

As economies enter the economic recovery phase, it will be important for policy makers in all countries to phase out policy support measures and focus on fostering a competitive business environment that is key to a strong recovery, resilience to future crises, and sustainable long-term economic growth. Policy recommendations include the following:

1. **Better targeting of government policy support measures going forward**

Broad, indiscriminate policy support schedules should be phased out as soon as appropriate; target remaining support to most productive firms, in order to avoid propping up zombie firms and ensure that limited fiscal resources are deployed efficiently.

2. **Ensuring that policy support measures do not lock in market structures that undermine competition**

Support measures should be designed transparently and subject to accountability so that risks of distorting market incentives or crowding out market players are minimized.

Governments should also take this opportunity to review the economic rationale of SOEs and consider whether government support to them is the best use of limited resources, especially if these enterprises had structural viability issues even before the crisis.

IV. Conclusions and Policy Recommendations

3. **Strengthening insolvency and resolution frameworks to enable improved firm exit**

As a result of the COVID crisis, many firms will need to restructure their debt, while others will need to be promptly resolved to ensure timely exit. Reforms to improve insolvency resolution are needed.

4. **Enabling improved firm entry and growth**

By improving the overall business environment and realigning policy and regulatory environments to facilitate the reallocation of resources toward long-run economic transformation, job creation, and inclusion.

5. **Ensuring financial system remains well-capitalized and liquid**

A strong financial sector is a vital part of a competitive business environment, facilitating healthy entry, exit and growth



Thank you!

Europe and Central Asia Chief Economist web page:

<http://www.worldbank.org/en/region/eca/brief/office-of-the-chief-economist-europe-and-central-asia>

ECA Economic Update:

<http://www.worldbank.org/en/region/eca/publication/europe-and-central-asia-economic-update>

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