Macroeconomic Implications of Size-Dependent Policies*

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Abstract

Government policies that impose restrictions on the size of large establishments or firms, or promote small ones, are widespread across countries. In this paper, we develop a framework to systematically study policies of this class. The economies we study are simple growth models with an endogenous size distribution of production units. Production requires a managerial input, and individuals sort themselves into managers and workers. Since managers are heterogeneous in terms of their ability, establishments of different sizes coexist in equilibrium. We parameterize the economies so that they are consistent with central properties of the data, both at the aggregate as well as the cross-sectional level. Then, we ask: quantitatively, how costly are policies that distort the size of production units? What is the impact of these policies on productivity measures, the equilibrium number of establishments and their size distribution? We find that these effects are potentially large: policies that reduce the average size of establishments by 20% lead to reductions in output and output per establishment up to 9.3% and 26.3% respectively, as well as large increases in the number of establishments (23.2%).

KEYWORDS: Size Distortions, Establishment Size, Productivity Differences.
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1 Introduction

Government policies that impose restrictions on the size of large establishments or firms, or promote small ones, are widespread across countries. These policies emerge in several forms: different countries implement policies that either restrict the operations of large production units, or subsidize small ones, or try to do both.

In some countries such policies can be extreme. In India, for instance, several products are reserved for small scale firms; simply put, these goods cannot be produced by large firms. The number of reserved products is not negligible, either. As of the late 1980s, production of these reserved items accounted for about 13% of total manufacturing output in India.\(^1\) A more widespread practice in many developing countries is the differential enforcement of taxes and other regulatory policies, as governments often find taxing or regulating larger units an easier task. These policies are by no means restricted to developing economies. Nearly all countries, poor and rich, provide an array of subsidies to small and medium size units. Labor market regulations in many OECD countries, like dismissal rules, bind only after a certain size. Finally, a number of rich countries, France, Japan, Germany and the U.K., implement policies that regulate the size and operation of establishments in the retail sector. In particular, Japan and France are unique among developed countries as they regulate heavily and at the national level the size of retail shops. In light of the prominence of policies of this type in developing and industrialized economies, we document them in greater detail in the Appendix.

In this paper we develop a simple framework to systematically evaluate policy distortions that depend on establishment or plant size. We refer to these as size-dependent policies. Our analysis is based on extensions of the well-known Lucas (1978) model. There is a single representative household, which is inhabited by individuals that are heterogenous in terms of their endowment of managerial skills. Production requires three inputs: capital, labor and managerial services. As a result of the underlying heterogeneity, individuals sort themselves between managers and workers. Furthermore, since those who become managers are heterogeneous in terms of their skills, establishments of different sizes coexist in equilibrium. We analyze two different types of policies: those that restrict production of large establishments

\(^1\)The Indian reservation policy remained essentially unchanged after the economic reforms of the early 1990’s. See the Appendix for a discussion.
and those that encourage production by small ones. We also extend our framework to a two-sector model, and introduce restrictions on the size of establishments in one of the sectors. In this case, we interpret one of the sectors as the retail sector and identify the other with the rest of the economy. In each scenario, we ask: quantitatively, how costly are policies that distort the size of production units? What is the impact of these policies on productivity? How do these policies affect the size distribution of establishments?

Our strategy to draw quantitative implications from size-dependent policies is to first restrict model parameters, in the absence of any distortion on size, in order to reproduce aggregate and cross-sectional observations of the U.S. This allows us to infer from data key model parameters: the degree of returns to scale at the plant level, the level of dispersion in managerial ability and the aggregate capital share. We subsequently introduce government policies that depend on the size of establishments, which we do via implicit taxes on large establishments or subsidies on small ones. We consider taxes and subsidies on inputs that kick-in at alternative levels of input use. Of course, given that in the model large and small production units coexist in equilibrium, different establishments will be affected differently by the policies; some will expand, some will contract, and new ones will emerge. In all the experiments we consider, distortions always result in an increase in the equilibrium number of establishments. We use this property of the model to impose a natural discipline to the quantitative exercises we carry out. In each of our experiments, we impose implicit taxes or subsidies that achieve common reductions in average establishment size.

We find that the consequences of the policies we study can be substantial. For instance, when establishment size is reduced by 20% via taxes on capital use, aggregate output falls by about 9.3% across steady states. These effects on output are systematically accompanied by sharp increases in the equilibrium number of establishments, while standard measures of productivity non-trivially drop. For this case, the number of establishments goes up by 23.2%, and average output per establishment drops by about 26.3%. This occurs not only under restrictions on large establishments, but also with subsidies to small ones, and also when policies are sector-specific. Finally, the policies we study also generate sizeable effects on the size distribution of establishments. Continuing with the same case, the coefficient of variation of size decreases from about 1.62 to 1.32 (in terms of employees), and the fraction of establishments that demand strictly more capital than the level of mean capital in the absence of restrictions declines from 22.9% to 8.7%.
We also find non-trivial welfare effects from these policies. A reduction in average size by 20% leads to welfare costs (in consumption equivalents) that range from about 0.65% to a high value of about 2.2% (including transitions across steady states). When the reduction in average size is obtained via implicit taxes on capital use by large establishments we find that the welfare cost is relatively high. Meanwhile when the same reduction in average size is accomplished via implicit taxes on labor use, the reduction in consumption is relatively small. Thus, our analysis strongly indicates that while different size-dependent policies can have similar effects on productivity measures and other observables, quantitatively, their potential effects on welfare depend critically on how a given average reduction in size is achieved.

**Background** Several observations make the study of size-dependent policies of special interest. First, large establishments account for a disproportionate fraction of output and employment. In the case of the United States, an economy for which the policies we study are largely absent, establishments with more than 100 workers correspond to 2.6% of the total number of establishments but account for 44.9% of total employment. This concentration of employment in large plants holds for the economy as a whole, for the manufacturing sector, as well as for the different sectors in the service area. Thus, it is natural to conjecture that policies that restrict the size of establishments are costly in terms of output and will impact productivity measures. The extent to which such policies can account for the large observed differences in productivity across countries documented by Klenow and Rodriguez-Clare (1997), Hall and Jones (1999) and Caselli (2004), among others, is an open question.

Second, the size distribution of establishments differs significantly across countries and available evidence suggests a central role for policy differences. Tybout (2000) summarizes evidence that shows a drastic contrast between size distributions of manufacturing plants in developing and industrial countries. In developing countries the size distribution of establishments shows a concentration of employment in small and large establishments with a missing middle group. This stands in contrast to the case of industrialized countries in developing countries and available evidence suggests a central role for policy differences. Tybout (2000) summarizes evidence that shows a drastic contrast between size distributions of manufacturing plants in developing and industrial countries. In developing countries the size distribution of establishments shows a concentration of employment in small and large establishments with a missing middle group. This stands in contrast to the case of industrialized countries in

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3Although we focus on the role of policy differences in this paper, there are obviously several factors that contribute to the cross country differences in size distribution, and these factors go well beyond the differences in government policies — see Kumar, Rajan, and Zingales (1999) for a recent review.
which the share of total employment rises with size.

Perhaps more interestingly, size distributions differ sharply even among countries of comparable levels of development. Differences among the U.S., the E.U. and Japan are noteworthy: small and medium size establishments play a significant role in Japan, but are much less significant in the U.S. with the E.U. being somewhere in the middle (European Commission (1996)). Surprisingly, the differences within the E.U. are also large. While small establishments account for the bulk of employment in Italy, larger establishments play a more important role in other countries, like Sweden and the U.K.\footnote{Establishments with 1 to 9 and more than 250 workers accounted for 45.8% and 21.5% of employment in Italy in 1991, while the same numbers were 29.2% and 44.5% in Sweden in 1992, and 13.4 and 50.2% in U.K. in 1993 — European Commission (1996).} Davis and Henrekson (1999) and Henrekson and Johansson (1999) argue that the economic policy environment plays a key role in the prevalence of large establishments in Sweden. They point out, among other things, the role of labor regulations that affect all establishments in Sweden but only the larger ones in other countries, like Italy.

Finally, restrictions on size in the retail sector might be of special importance. In the first place, there is evidence of substantial productivity growth in services, and in the retail sector in particular. According to Basu, Fernald, Oulton, and Srinivasan (2003), productivity growth in wholesale and retail trade between 1995 and 2000 was the second highest among all sectors in the U.S., second only to information technology producing sectors. In the second place, the experience of the Japanese retail sector, where size is heavily regulated (see Appendix), is illustrative. Japanese retailing is characterized by (i) a relatively large number of stores per capita, (ii) a large concentration of employment and hours worked in small establishments, and (iii) low productivity. The first fact is documented by Flath (2003), among others, who reports that there are about 11.2 stores per 1000 population in Japan, while the same number is 6.1 in U.S. For the second fact, we note that while retail establishments with more than 100 workers accounted for 32% of employment in the sector in the United States in 1997, they accounted for just 12% of retail employment in Japan in 2001.\footnote{Sources: U.S. Economic Census (1997) and Japan’s 2001 Enterprise and Establishment Census, which is available at \url{http://www.stat.go.jp/english/data/jigyou/index.htm}.} Similarly, according to McKinsey Global Institute (2000), the share of traditional mom-and-pop stores in total hours worked in retailing is about 55% in Japan and 19% in the U.S. For the last fact, McKinsey Global Institute (2000) and Baily and Solow (2001)
document that output per worker in merchandise retailing in Japan was about half of the level in the U.S. in 2000 at common prices. To put this figure in perspective, aggregate output per worker in Japan was about 70% of the U.S. in 2000.

**Related Literature** This paper is connected to the growing macroeconomic literature that analyzes the relationship between distortions (like entry and exit barriers, barriers to technology adoption, limited contractual enforcement, etc.) and differences in economic performance. Bergoeing, Kehoe, Kehoe, and Soto (2002), Burstein and Monge (2005), Caselli and Gennaioli (2002), Chu (2002), Erosa and Hidalgo (2005), Gollin (1995), Herrendorf and Teixeira (2004), Lagos (2004), Schmitz (2001), Parente and Prescott (2000), Restuccia (2004), Restuccia and Rogerson (2003), among others, are examples of papers in this group. Restuccia and Rogerson (2003) is in particular close to the current paper, as they share our emphasis on policies that hinge on establishment size. These authors argue that policies that affect the allocation of resources across production establishments via idiosyncratic distortions (e.g. distortions that are establishment specific that can vary with size) can have quantitatively important consequences for output and productivity. They conduct their analysis in a model with entry and exit like Hopenhayn and Rogerson (1993) and Veracierto (2001), but with no stochastic evolution of productivity for a plant after entry and exogenous exit. One key difference between our paper and theirs is that our analysis systematically associates size-dependent policies, both restrictions on size as well as subsidies to small units, to increases in the number of establishments. In Restuccia and Rogerson (2003) this outcome does not necessarily occur.

The rest of the paper is organized as follows. Section 2 introduces the model economy we investigate. Section 3 discusses our choice of parameter values. Section 4 presents the findings from our experiments in our benchmark case. Section 5 studies restrictions on size that are sector specific. Section 6 investigates other size-dependent policies. Section 7 concludes. Finally, in the Appendix we describe in detail key examples of size-dependent policies across countries.
2 Theoretical Framework

We now describe a simple one-sector aggregative model with an endogenously determined size distribution of plants or establishments. The model is based upon the Lucas (1978) span-of-control framework. We first present the model economy in the absence of any policy. In subsequent sections we introduce size-dependent policies of different types and extend the model to multiple sectors to accommodate policies that are sector specific.

The economy is inhabited by a single representative household. The household is comprised at time $t$ by a continuum of members of total size $L_t$, who value only consumption. The size of the household (population) grows at the constant rate ($g_L$). The household is infinitely lived and maximizes

$$\sum_{t=0}^{\infty} \beta^t L_t \log(C_t/L_t),$$

where $\beta \in (0, 1)$ and $C_t$ denotes total household consumption at date $t$.

**Endowments** Each household member is endowed with $z$ units of managerial ability. These efficiency units are distributed with support in $Z = [0, \bar{z}]$ with cdf $F(z)$ and density $f(z)$. Depending upon type, each household member can be a *worker* or a *manager*. We describe below this occupation decision and the associated incomes in detail.

**Production** A manager of type $z \in Z$ has access to the technology

$$y = z^{1-\gamma} A(g(k, n))^{\gamma},$$

where $g(\ldots) = k^{\nu} n^{1-\nu}$ and $0 < \nu < 1$. The parameter $\gamma$ governs returns to scale at the plant level (usually referred to as the span-of-control parameter), and satisfies $0 < \gamma < 1$. Thus, production requires a managerial input ($z$), capital ($k$), and labor ($n$). The term $A$ is common to all production units, and accounts for exogenous productivity growth at the constant rate $g_A$ (i.e. $A_{t+1}/A_t = 1 + g_A$). A manager with ability $z$ maximizes profits taking input prices as given and obtains $\pi(z, w, R)$, which is the solution to

$$\max_{n,k} [z^{1-\gamma} A(g(k, n))^{\gamma} - wn - Rk],$$

where $w$ and $R$ are the rental prices for labor and capital services respectively.
The Household Problem  The problem of the household is to choose sequences of consumption, the fractions of household members who work as managers or workers, and the amount of capital to carry over to the next period.

If a household member becomes a worker, her efficiency units are transformed into 1 unit of labor and her income is then given by $w$. If instead she becomes a manager, her contribution to household’s income is given by $\pi(z, w, R)$. Note that there exists a unique threshold $\hat{z}$ such that those individuals with efficiency units below this threshold become workers, and those with efficiency units above it become managers. This follows from the fact that the function $\pi(., w, R)$ is strictly increasing in the first argument under diminishing returns to capital and labor jointly.

Formally the household problem is to select $\{C_t, K_{t+1}, \hat{z}_t\}_{0}^{\infty}$ to maximize (1) subject to

$$C_t + K_{t+1} = I_t(\hat{z}_t, w_t, R_t)L_t + R_tK_t + K_t(1 - \delta),$$

and

$$K_0 > 0.$$

The per-capita income from managerial and labor services, $I_t(\hat{z}_t, w_t, R_t)$, is given by

$$w_tF(\hat{z}_t) + \int_{\hat{z}_t}^{\bar{z}} \pi(z, w_t, R_t)f(z)dz.$$

The solution to the household problem is then characterized by the First Order Conditions:

$$\frac{1}{(C_t/L_t)} = \beta(1 + R_{t+1} - \delta)\frac{1}{(C_{t+1}/L_{t+1})},$$

and

$$w_t = \pi(\hat{z}_t, w_t, R_t).$$

Condition (2) is the standard Euler equation for capital accumulation. Condition (3) states that the household member with marginal ability $\hat{z}_t$ at $t$ must receive the same compensation as a manager than as a worker (e.g. be indifferent).

Equilibrium  In equilibrium, the markets for capital and labor services, as well as the market for goods must clear. Let $n(z, w, R)$ and $k(z, w, R)$ be the demands for capital and
labor services of a manager of ability \( z \). Market clearing in the market for labor services requires

\[
N_t^* = L_t \int_{z_t^*}^{\bar{z}} n(z, w_t^*, R_t^*) f(z) dz,
\]

(4)

where an \( (*) \) over a variable denotes its equilibrium value, and \( N_t^* \), aggregate labor supply at \( t \), is given by

\[
N_t^* \equiv L_t F(\hat{z}_t^*).
\]

Market clearing in the market for capital services requires:

\[
K_t^* = L_t \int_{z_t^*}^{\bar{z}} k(z, w_t^*, R_t^*) f(z) dz.
\]

(5)

Let \( y_t(z, w_t, R_t) \) be the supply of goods by managers with ability \( z \). Then, market clearing in the market for goods requires:

\[
L_t \int_{z_t^*}^{\bar{z}} y(z, w_t^*, R_t^*) f(z) dz = C_t^* + K_{t+1}^* - K_t^* + \delta K_t^*.
\]

(6)

It is now possible to define a competitive equilibrium. A competitive equilibrium is a collection of sequences \( \{C_t^*, K_{t+1}^*, \hat{z}_t^*, w_t^*, R_t^*\}_0^\infty \), such that (i) given \( \{w_t^*, R_t^*\}_0^\infty \), the sequences \( \{C_t^*, K_{t+1}^*, \hat{z}_t^*\}_0^\infty \) solve the household problem; (ii) the markets for capital and labor services clear for all \( t \) (equations (4) and (5) hold); (iii) the market for goods clears for all \( t \) (equation (6) holds).

Along a competitive balanced growth path, the rental rate of capital services is constant. Per-capita consumption and output, wages and managerial profits all grow at the common rate rate \( 1 + g \equiv (1 + g_A)^{1/(1-\gamma)} \), and the threshold \( \hat{z}^* \) is constant. Aggregate output, consumption and capital grow at the rate \( (1 + g_L)(1 + g) \).

**Discussion** Some implications of the framework are important to note at this point. First, since all individuals face the same wage rate as workers, the size of the smallest and the average establishment can differ significantly. They depend critically on the parameter governing span-of-control: \( \gamma \). This model feature is key for our application of the model to the questions at hand. In the data, large establishments coexist with small ones in all
sectors. Policies aimed at large establishments can potentially have important consequences, as these units account for a disproportionate fraction of total employment. Thus, accounting for large establishments is important to reproduce features of the data and to assess the potential effects of policies on size.

Second, the competitive equilibrium is unique, and coincides with the Social Planner solution in the absence of distortions. This implies that any policy affecting size will be distorting.\footnote{Of course, this does not imply that size regulations are always inefficient. They would be efficient, for example, if large plants generate negative externalities.} Our analysis can thus be viewed as a natural benchmark to analyze the consequences of policies of this type: what effects are to be expected on a host of variables in equilibrium, and what the magnitude of such effects will be.

Finally, the fact that the standard Euler equation for capital accumulation applies in this model implies that the rental rate for capital services is constant across steady states. This suggests a simple and natural procedure to compute steady state equilibria. First, we normalize variables to remove the effects of secular growth. We then (i) guess a value of the normalized steady-state capital stock; (ii) given this value, calculate equilibrium factor prices from equations (4) and (5); (iii) if the resulting rental rate for capital services differs from \((1 + g)/\beta - 1 + \delta\), update the capital stock and start anew. Otherwise, a steady state equilibrium has been found. This procedure, which also applies when government policies are introduced, is the one we use to calculate all the statistics we report in the paper.\footnote{Note that due to productivity growth, the stationary version of the model dictates that the Euler equation for capital (equation 2) includes the term \((1 + g)\).}

3 Parameter Values

We now choose parameter values in order to compute solutions to our model, which we do by selecting most of them so as to match a number of critical observations in steady state, both at the aggregate and at the cross-section level. To this end, we use data pertaining to the United States, which we take as a relatively distortion-free economy for the purposes of this paper.

As a first step in this process, we choose a model period of a year and proceed to adopt a notion of capital for measurement purposes. We assume that the stock of capital is comprised by business equipment and structures, business inventories and business land. From the
NIPA data published by U.S. Department of Commerce (2005), Table 1.3.5, we take the flow of output consistent with this notion of capital, which is GDP accounted for by the business sector. For the period 1960-2000, the capital to output ratio associated to these choices averaged about 2.325. For this period, output growth was about 3.67% at the annual level. Given corresponding annual population growth rate of about 1.1%, the implied measure for the technical growth rate $g$ is 2.55%.

We then proceed to measure the share of capital in total output and the depreciation rate. Using the methodology described in Cooley and Prescott (1995), the share of capital averaged about 0.317 for the period 1960-2000. Using depreciation data from NIPA (Table 5.2.5) consistent with the notion of the capital we adopt, the depreciation rate for this period averaged about 0.040. Since in our economy the share of capital equals $\gamma \nu$, and since $\gamma$ is a critical parameter determining size, we set these parameters so that the model is consistent with both the aggregate capital share and mean establishment size. For the latter target, we use establishment data from the 1997 U.S. Economic Census for all sectors covered. From this data we calculate that the mean establishment size was 17.09 workers. Given all these choices, we select the discount factor $\beta$ in order to reproduce the aforementioned capital to output ratio in steady state.

We assume that the distribution of potential managerial ability is log-normal, so that $\log(z) \sim N(0, \sigma)$. In order to pindown $\sigma$, we add an observation relevant to the questions at hand, namely the dispersion in establishment size (in terms of workers). From the 1997 U.S. Economic Census, we calculate that the coefficient of variation for this variable for all sectors equalled 1.62. This high level of dispersion in establishment size is hard not to emphasize. To put this in perspective, we note that this distribution is much more disperse than the distribution of labor earnings in the U.S., which has a coefficient of variation of about 0.7.

**Discussion** There are in total four parameters that we choose in order to reproduce observations. These are $\gamma, \nu, \sigma$ and $\beta$. Table 1 summarizes our choices. Table 2 lists the set of observations that constitute our targets, and shows the performance of the model in terms

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8 The sources for the stock of business capital and structures is Lally (2002), Table 1. The sources for the stock of business land are the recently published series by the Bureau of Labor Statistics from their Multifactor Productivity Program. We use the stocks of land reported as part of the productive capital stock. This is available at ftp://ftp.bls.gov/pub/suppl/prod3.capital.zip.

9 See Haider (2001) for instance.
of them. The model has no problem in reproducing these targets, as the table demonstrates. Figure 1 shows that the model also reproduces well the shape of the actual size distribution.

In the model, about 94.5% of the labor force are workers while the remaining fraction are managers. Regarding the consistency of these values with data, it is worth noting that pinning down an empirical value for the fraction of workers (managers) is difficult. From census data, it is possible to calculate a lower bound on the fraction of workers, as about 85.7% of the labor force performed non-managerial tasks in 2001.\textsuperscript{10} Chang (2000), using PSID data, calculates a similar value for the fraction of workers (84%). Nevertheless, a more literal interpretation of the model economy, which we prefer, suggests that each establishment is run by one manager. This consideration suggests a lower bound on the fraction of managers, which can be obtained by dividing the number of active establishments in 1997 by the size of the work force in that year. This calculation leads to a fraction of workers in the population of about 95%. Note that the model generates a similar value (94.5%), which follows since the model reproduces number of workers per establishment (i.e. mean establishment size).

Finally, note that the model implies that mean size is constant along the balanced growth path. We emphasize that this property is in conformity with available data. Using available time-series data from the County Business Patterns, we find that average size is trendless despite productivity growth. For instance, mean size was 15.94 in 1969, 16.47 in 1980, 14.22 in 1985, 15.13 in 1990, 15.17 in 1995 and 16.13 in 2000. Note that we use a different source of data (Economic Census) for calculating the statistics on size that we report previously. As a result, our target in Table 2 differs slightly from these numbers.

4 Size-Dependent Policies

Our representation of policies is meant to capture government policies which affect the size of establishments via implicit taxes or subsidies on input use. Our analysis thus provides bounds for the effects of size-dependent policies that directly tax/subsidize output. We discuss in this section the case of \textit{restrictions} on size, which we model as implicit taxes that are applied only to the input units above an exogenously set level. The central

\textsuperscript{10}Source: U.S. Census Bureau (2002), Table 588. This results from considering individuals under the occupation category “Executive, Administrative and Managerial”.

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idea is that if an establishment wants to expand the use of an input beyond a given level, it faces a marginal cost of using the input in question that is larger than its price.

We focus first on restrictions imposed on the use of capital; the case of restrictions on labor use is similar and we analyze it later. We posit that the total cost associated to capital use beyond a pre-determined level $k$ is given by

$$R_k + R(1 + \tau)(k - k),$$

for some $\tau \in (0, 1)$. If $k \leq k$, then the total cost of capital use is just $R_k$. Note that this resembles a progressive tax, in which there are two implicit marginal tax rates, 0 and $\tau$. If $k > k$, the production unit pays $R_k$ for the first $k$ units used, plus an amount that is proportional to the difference between $k$ and $k$.

This modelling of restrictions implies that the total cost associated to capital use is continuous in $k$. As a result, the function $\pi(.)$ summarizing managerial rents, and establishment’s demand functions for capital and labor are continuous. Profit maximization dictates that there are potentially three types of establishments. Unconstrained ones are small establishments that choose $k(z, w, R; k, \tau) \leq k$. Thus, for these establishments the marginal product of capital equals the rental rate $R$. On the other extreme, are those whose managers have relatively high levels of $z$, and thus choose $k(z, w, R; k, \tau) > k$. For these units, the marginal product of capital is higher than the rental rate. Finally, there is an intermediate group of establishments for which the marginal product of capital is undefined. For these, $k(z, w, R; k, \tau) = k$. Since the demand for capital services is continuous and increasing in managerial ability, this ordering is mapped into levels of managerial ability. Hence, there exist thresholds $z^-$ and $z^+$ so that: (i) unconstrained establishments are those with $z \in [\hat{z}, z^-)$; (ii) establishments in the intermediate group are those for which $z \in [z^-, z^+)$; (iii) the largest establishments have $z > z^+$.

It is important to note here that an implication of the model without distortions is that all establishments choose the same capital to labor ratio, regardless of their size. The reason for this is the assumption of constant returns to scale in the function $g(k, n)$, and the fact that all of them face the same prices for capital and labor services. With distortions on size, this is no longer true. It can be shown that under these circumstances, the capital labor ratio is a weakly decreasing function of managerial ability, as Figure 2 illustrates. When
restrictions are imposed on the use of labor services, or when government policy encourages capital use by small establishments, the opposite is true (see sections 4.2 and 4.3).

We now briefly describe the modified household problem under restrictions on size. Resources taxed via restrictions on size are returned to the representative household in a lump-sum form. Formally, the household’s budget constraint now equals

\[ C_t + K_{t+1} = I_t(z_t, w_t, R_t; k, \tau) L_t + R_t K_t + K_t(1 - \delta) + X_t, \]

where \( X_t \) stands for lump-sum transfers which are taken as given by the household. In equilibrium, they equal

\[ X_t^* = L_t R_t^* \int_{z^*}^{z^+} \left( k(z, .) - k \right) f(z) dz. \]

4.1 Findings

We proceed by comparing steady states of our model economy without distortions with steady states of a distorted model economy in different cases. We report results for restrictions that kick-in at average capital use in the economy without restrictions. We report results for two scenarios, given by the values of the tax rate (\( \tau \)) such that 10% and 20% reductions in average size across steady states is accomplished. Given the absence of empirical counterparts for implicit tax rates, this form of reporting findings provides a natural discipline for an assessment of the effects of the policies we study.\(^{11}\) Furthermore, the reduction in average size of establishments that these distortions generate is well within differences we observe among industrialized countries: according to European Commission (1996) the average production unit in European Union has about 23% less employees than the ones in the U.S., while the gap between the U.S. and Japan is of about 40%.\(^{12}\) Therefore, the 20%

\(^{11}\)We have verified that given our discipline of targeting common reductions in average size, the magnitude of the effects on aggregates and productivity we report below do not effectively depend on the location of the distortion in the size distribution. What a lower value of \( k \) simply does is to reduce the implicit tax required to achieve a given reduction in size. Thus, what matters in the context of these exercises is the magnitude of the distortion measured by the reduction in average size, and not how such reduction is obtained (either via thresholds or via implicit taxes).

\(^{12}\)The unit of observation in European data is an enterprise, which can have more than one production unit and thus it falls somewhere between a firm and a plant. As a result, the reported difference in average size between the U.S. and the E.U. is a lower bound. The observations reported above are based on comparisons between enterprises with paid employees.
reduction experiment should be viewed as a conservative representation of policy-driven differences in size across industrialized countries. The 10% reduction in size experiment serves to highlight how results vary as restrictions become more severe.

**Aggregates**  Table 3 summarizes the main findings for aggregate variables. When restrictions on capital use lead to a reduction in average establishment size of 20% (10%) across steady states, aggregate output falls by 9.3% (4.9%), aggregate capital falls by 23.2% (13.7%) and aggregate consumption falls by 6.2% (2.9%). When $\tau$ increases, affected establishments either set their demand for capital services at $k$, or demand capital services from a new, higher price $R(1 + \tau)$. This process leads to a reduction in the total demand for capital services, a reduction in the capital to labor ratio in distorted establishments, and a reduction in the supply of the single good produced. In equilibrium, this process is accompanied by an increase in the number of small establishments as Table 3 shows, as well as an expansion of establishments not affected by the increase in the implicit tax ($\tau$). It is worth emphasizing the phenomenon that total output decreases, despite the emergence of new, small establishments and the expansion of undistorted ones; this simply reflects the fact that large (distorted) ones account for a disproportionate share of total output.

We note that the increase in the number of small establishments is a simple and natural implication of our framework. Quantitatively, this increase in the number of small establishments is substantial, ranging from about 10.9% when mean size declines by 10% to about 23.2% when the reduction is 20%. Why does this phenomenon occur? The introduction of restrictions on large establishments leads to a reduction in the aggregate demand for labor, and thus to a new steady state with a lower wage rate. Provided that the rental rate on capital services is constant across steady states, the fall in wages increases the managerial rents associated to operating small, undistorted establishments. In addition, the fall in the wage rate reduces the benefits of being a worker. The net result is the reduction in the productivity threshold $\hat{z}$, and the non-trivial increase in the number of small establishments that Table 3 shows.

**Productivity**  The distortions on size have systematically a direct and negative impact on productivity measures. We report in Table 3 several of them. The first one is simply average output per worker (non-managers). We also report the behavior of output per
establishment, output per efficiency unit of labor (managers plus workers), as well as average managerial quality. These measures are defined as

$$\frac{\int_{z^*} y(z, w^*, R^*) f(z) dz}{(1 - F(\hat{z}^*))},$$

$$\frac{\int_{z^*} y(z, w^*, R^*) f(z) dz}{F(\hat{z}^*) + \int_{z^*} z f(z) dz},$$

and

$$\frac{\int_{z^*} z f(z) dz}{(1 - F(\hat{z}^*))},$$

respectively. For a reduction in mean size of 20% (10%) across steady states, output per worker drops by about 8.0% (4.2%). The reduction in output per establishment and average managerial quality are much more pronounced; the fall in these magnitudes for a reduction in mean size of 20% (10%) are 26.4% (14.2%) and 16.3% (8.3%), respectively.

What is behind the decline in these productivity measures? Overall, the reductions in productivity measures reflect the negative consequences that size restrictions have on the allocation of the economy’s fixed endowment of managerial talent, and the general equilibrium effects that ensue. Table 4 illustrates how distortions affect the allocation of managerial talent, by calculating the fraction of total output accounted for by managers at different quintiles of the distribution of managerial ability. In the benchmark economy without distortions about 3.7% of the total output is produced by managers who constitute the bottom 20% of the managerial ability distribution, while about 66.7% of total output is produced by the top managers. What happens when we introduce the restrictions on size? Consider for instance the situation when average establishment size is reduced by 20%. In this case, the fraction of output accounted for by the top 20% of managers declines significantly, to about 56.5%. Meanwhile, output accounted for by less talented managers expands at the bottom of the distribution. Thus, restrictions on large establishments not only reduce average size and increase the number of establishments that operate in equilibrium, but also redistribute production from high ability to low ability managers.

With the distortions in the allocation of managerial talent illustrated in Table 4, total output as well as total demand for labor and capital decline and the general equilibrium effects on prices follow. We now concentrate in detail on the effects of the restrictions on one of the productivity measures, output per worker, to illustrate these general equilibrium
effects. Why does this statistic drop across steady states? This is important to understand, as this is a statistic usually computed in productivity studies. In each establishment, physical output per worker equals

\[ \frac{w^*}{(1 - \nu)^\gamma}, \]

independently of the presence of restrictions on size as we modelled them. Thus, absent general equilibrium effects, size restrictions applied to the use of capital do not affect output per worker, despite the emergence of establishments with relatively low output and the reduction in output in large, distorted ones. As a result, the fall in output per worker reported in Table 3 is also the fall in the wage rate across steady states associated to the restrictions on large establishments.

**TFP** An alternative, admittedly imperfect, measure of how the reallocation of managerial talent affects aggregate output are the implications of our analysis for Total Factor Productivity (TFP). We calculate this variable in two alternative ways. The first is consistent with cross-country studies (e.g. Klenow and Rodriguez-Clare (1997)); that is, TFP is the residual from an aggregate technology under a capital share \( \nu \gamma \) and a labor share \( 1 - \nu \gamma \), under the assumption that there are no distinctions between workers and managers in the labor force. Concretely, we calculate

\[ TFP = \frac{Y/L}{(K/L)^{\nu \gamma}}. \]

For this measure, we find that these policies have effects on TFP of small magnitude; reducing size by 20% leads to a reduction in TFP of about 1.4%. Alternatively, we can separate workers and managers by their efficiency units and define aggregate labor as \( N + Z \), where \( Z \equiv L \int_{\hat{z}}^{\bar{z}} z f(z) dz \). For this case, we have:

\[ TFP = \frac{Y}{(K)^{\nu \gamma} (N + Z)^{(1 - \nu \gamma)}}, \]

and a 20% reduction in average size implies a reduction of about 3.4%.

Two comments are in order regarding these calculations. First, since distortions on capital use that reduce average size by 20% result in a 9.3% decline in output, a non-trivial portion of this decline can be viewed as accounted for by the aforementioned reallocation process.
Second, it is important to bear in mind that in the one-sector model without an endogenous size distribution, a distortionary capital income tax would have no effect on TFP.

**Size Distribution Effects** Table 5 shows that restrictions on capital use have large consequences on the size distribution of establishments. We note first that, albeit moderately, median establishment size increases as mean size declines across steady states. This occurs in spite of the emergence of small establishments at the bottom of the distribution. This phenomenon is accounted for by the expansion of existing undistorted establishments in response to the drop in wage rates across steady states. Dispersion in size, measured by the coefficient of variation, drops as Table 5 indicates. Several forces influence the behavior of this statistic. On the one hand, everything else constant, the emergence of new, small establishments tends to increase dispersion. On the other hand, the reduction in the size of distorted establishments reduces dispersion, while the increase in the size of undistorted ones has an uncertain effect. Overall, the effects that lead to a reduction in dispersion dominate, as the results show.

It is worth emphasizing the effects that restrictions have upon the mass of establishments at or above $k$, the level where these restrictions kick-in. In the first place, note that the restrictions create a sizeable mass of establishments concentrated at $k$: the mass of establishments at this level jumps from theoretical level of zero in the undistorted case, to values of 8.2% to 14.7%. Both the contraction of some establishments, which now demand capital services at $k$, and the expansion of undistorted ones account for this phenomenon. Second, the increase in the magnitude of the distortion does not change significantly the overall mass of distorted establishments (that is, those demanding $k \geq k$). This phenomenon can lead to an erroneous conclusion, such as that an increase in the severity of the restrictions does not matter. To see this, notice that the increase in the implicit tax rate leads to a significant decrease in the number of establishments strictly above $k$. Quantitatively, this magnitude drops from the undistorted value of 22.9% to 15.4% when the reduction in mean size is of 10%, and to about 8.7% when the reduction is of 20%.

**Discussion** We now discuss and evaluate the results in more detail. As we indicated earlier, consumption and output drop in a significant way across steady states. Our analysis then leads to large welfare gains (costs) from eliminating (introducing) policies that restrict
capital use which lead to only moderate reductions in average size. Table 3 shows that in consumption equivalent terms, reducing size by 20% across steady states implies a welfare cost of about 2.2% (including transitions). These welfare costs are large by the standards of the applied general equilibrium literature.

We now try to understand the findings in more detail. First, what is the quantitative importance of capital accumulation in generating the large effects on output and consumption? To answer this question, recall that the capital stock declines substantially across steady states as restrictions are introduced. To further quantify the relative importance of capital accumulation, we look at the effects of restrictions on capital use using the implicit tax rates reported in Table 3, but when the aggregate capital stock is kept at its benchmark level.\textsuperscript{13} We find that for a reduction in mean size of 20% (10%), aggregate output declines by about 1.4% (0.3%). That is, in the absence of capital accumulation the resulting effects on output are lower by several orders of magnitude. Not surprisingly, accounting for changes in the capital stock is crucial to assess the effects of restrictions on capital use; for aggregate such as output and capital, these restrictions act as a capital income tax.

Second, how big are the distortions that we impose on the model economy in the quantitative exercises? Surprisingly, they are not large. First, note that in our experiments only about 22.9% of establishments are affected by size restrictions, and only about 8.7% and 15.4% of the establishments effectively pay the implicit tax on capital services in each case. Furthermore, the establishments that pay this tax, only pay a penalty on the amount of capital they rent above the threshold level, $k$. Indeed, one can calculate in this economy the total value of tax payments as a percentage of total payments for capital services. This calculation gives an average tax rate on payments to capital equal to

$$
\frac{\tau \int_{\hat{z}}^{z^{*}} (k(z, w^{*}, R^{*}) - k) f(z) dz}{\int_{\hat{z}}^{z^{*}} k(z, w^{*}, R^{*}) f(z) dz}.
$$

In our experiments this average tax rate turns out to be relatively small. It ranges from about 5.8% when the reduction in average size is 10%, to 7.5% when the reduction is 20%. To account for the significant effects on output in Table 3, note that while average tax rates are low, the implicit tax rate $\tau$ affects the decisions at the margin of large establishments, which

\textsuperscript{13}Formally, we compute equilibria when the representative household is endowed with the steady state capital stock in the absence of restrictions.
have substantial effects on input markets and lead to the changes in the capital accumulation we discussed above. Note that these establishments account for the bulk of output: in the undistorted economy, establishments above the median size are responsible for about 87.32% of total output, while establishments above the mean account for about 70.46%.

A more systematic way to assess how costly these restrictions are, is to ask: What are the consequences of taxing uniformly the use of capital across all units so that the same revenue is generated? We note first that average size is unaffected by this experiment since the common tax is now paid by all establishments. The fact that all establishments pay this tax also determines that the tax rates that solve this problem are much smaller than the marginal tax rates in the size-dependent case: 6.3% vs 45% and 5.5% vs 18%. More importantly, the output effects are substantially smaller. The marginal tax rate that generates the revenue corresponding to a 20% (10%) reduction in mean size now leads to a drop in output of about 2.8% (2.5%). These results indicate that the effects of these policies on output and capital are mainly driven by the underlying “progressivity” of the implicit tax schedule, and not by the levels of average taxes on capital use.

**The Role of Returns to Scale** We now assess the importance of the curvature parameter $\gamma$ for the results presented so far. This is a key parameter for the current analysis. It affects directly who wants to be a manager, and as a result, the average size of establishments and average managerial quality. It also determines how sensitive establishment size and output are to factor prices. Furthermore, there is some uncertainty and debate with respect to the empirical value of returns to scale at the plant level. Basu and Fernald (1997) for instance, estimate values that range from 0.8 to 1, and argue that there is an upward bias in estimates from aggregated data. Atkeson, Khan, and Ohanian (1996) analyze the link between firing costs and gross job flows within an industry evolution model, and argue, by contrasting manufacturing job flows from the U.S. with other O.E.C.D. countries, that a value on the low side of the above estimates is reasonable.

We emphasize that some discipline is needed in order to evaluate the effect of size-dependent policies under different degrees of return to scale at the plant level. First, note that everything else constant, as $\gamma$ increases each establishment becomes larger. Thus, the threshold value, $k$, changes with $\gamma$. In addition, since the response of establishments to changes in factor prices depends on the degree of returns to scale, a higher value of $\gamma$ implies
a larger response to the introduction of restrictions on size. From this perspective, a larger value of $\gamma$ should be accompanied by a lower implicit tax rate to achieve a given reduction in mean size. Second, a larger value of $\gamma$ implies a larger aggregate capital share, since the latter is given by $\nu\gamma$ and thus adjustments on $\nu$ are necessary. Finally, as we already noted, an increase in $\gamma$ should lead to an increase in mean size. Hence, a further adjustment is in order if one wants to compare two economies with the same mean establishment size.

In Table 6 we report the effects on aggregate output of reducing size by 20% for $\gamma = 0.85$ and $\gamma = 0.9$. To highlight the role of different margins, we report results in a progression of experiments. In the first experiment, we simply change $\gamma$ and leave all other parameters (except $k$ and $\tau$) at their benchmark values. Consistent with our discussions above, average size increases with $\gamma$. It is 19.84 with $\gamma = 0.85$ and 26.76 with $\gamma = 0.9$, while it was 17.09 in the benchmark economy. The implicit tax rate that achieves a 20% reduction is also lower; about 35% with $\gamma = 0.85$ and about 20% with $\gamma = 0.9$, while it was 45% in the benchmark economy. In the next experiment, we adjust the parameter $\nu$ so that the capital share is consistent with the benchmark. In the final experiment we also adjust the dispersion parameter $\sigma$ so that both the capital share and mean size are consistent with the benchmark.

The results show that the reduction in output associated to a reduction in size for higher values of $\gamma$ is lower than in the benchmark case (about 9.3%). This occurs even in the absence of adjustments to keep the capital share and mean size constant. Hence, the presence of large establishments per-se does not necessarily imply a larger cost from size-dependent policies. Note that, as expected, the reduction in output declines as these adjustments are made. The reason for this is that with the first adjustment, the importance of capital in production is reduced and thus, the impact of restrictions on capital use across steady states. Subsequently, in order to keep mean size constant, the dispersion parameter $\sigma$ is reduced as well. The result is a reduction in the relative importance of large establishments and thus, the impact of restrictions on capital use is even smaller.

### 4.2 Restrictions on Labor Use

We now discuss the implications of size restrictions when they depend on the use of labor services beyond a threshold value. This is an empirically relevant case as we discuss in the Appendix. Table 7 summarizes the main results. In line with the previous case we set the
threshold value, $n$, to mean labor use in the economy without restrictions and again, we
report results for implicit tax rates leading to reductions on average size of 10% and 20%.

We now discuss key aspects of these results, and relate them to previous case. First,
when restrictions depend on the use of labor services, a given implicit tax rate can achieve a
larger reduction in average size. To understand this, note that unlike the case of restrictions
on capital use, restrictions on labor use have a first-order effect on the market for labor
services. This follows since establishments substitute away from labor into capital, while
total output produced declines. The result is a reduction in the equilibrium wage rate across
steady states that is larger than when restrictions depend on capital use. Thus, by creating
larger changes in the demand for labor services these policies provide larger incentives for
the emergence of new, small establishments. This, together with the direct effects on large
establishments, contributes to a larger reduction in mean size and size dispersion associated
to a given implicit tax rate. The natural implication is that in order to achieve the average
reductions in size that we target, lower implicit tax rates are needed, as Table 7 demonstrates.
For instance, when the the reduction in average size is 10%, the implicit tax rate equals 7.3%
in the case of restrictions on labor use while it is about 18.0% for restrictions of capital use.

Second, note that output per worker falls by less than in the case when size restrictions
depend on capital use. To understand this finding, it is key to bear in mind that for large
establishments which pay the implicit tax, output per worker equals

$$w^* \left(1 + \frac{\tau}{1 - \nu}\gamma\right).$$

Hence, for fixed wage rates, output per worker goes up for establishments that pay the
implicit tax. There are then two opposing forces that operate as $\tau$ increases across distorted
and undistorted steady states. On the one hand, wage rates fall, reducing output per worker
of establishments not paying the implicit tax. On the other hand, relatively large establish-
ments become also high output per worker establishments due to the payment of the implicit
tax. Put differently, large establishments appear to be more productive precisely because of
the restrictions on their size.

Finally, we note that the effects on aggregate output in this case are several orders of
magnitude smaller. For a 20% (10%) reduction in mean size output falls 0.81% (0.18%) across
steady states, while under restrictions to capital use the corresponding reduction is about
9.3% (4.9%). The simple yet important implication of this finding is that the quantitative effects on output and potentially welfare of policies that restrict size depend crucially on how they are implemented. Put differently, we show that two alternative policies that imply the same reduction in size and have similar effects on productivity measures and the number of establishments, can have quantitative consequences on output and potential welfare that are very different. In the current case, the policies in question have little affect on the aggregate capital stock as distorted plants become more capital intensive and thus, the net effects on aggregate capital are relatively small. In the case of restrictions on capital use, the opposite occurs. The policy implication that emerges from our analysis is then clear; size-dependent policies that depend on capital use, like the ones prevailing in India for example, are costlier than alternative ones as they have a large effect on the economy’s capital stock in the long run.

**An Application: Restrictions on Labor Use in Italy** So far we have analyzed the consequences of size-dependent restrictions by purposefully focusing on abstract reductions in mean size, which are accomplished via implicit taxes. We study below an application of our model economy to the case of size-dependent restrictions of labor use in Italy, which offers a concrete and transparent example of these policies. As we document in the Appendix, a number of labor regulations kick-in at the level of 15 employees that are applied to firms and establishments in the whole economy. Not surprisingly, mean size in Italy is not only smaller than in the United States, but also smaller than in other E.U. countries; according to European Commission (1996), mean size of enterprises with salaried workers in Italy is just about 42% of the average of the EU-15 group.

We study the case in which if an establishment wants to expand input use beyond a limit, it faces implicit taxes on all input units (marginal and inframarginal). This is a more accurate representation of the policies in place than the benchmark cases we analyzed previously. If labor use is \( n > n \), the cost associated to labor services equals \( w(1 + \tau)n \), while this cost equals \( wn \) if \( n \leq n \). Therefore, labor costs are discontinuous at \( n \). There are then thresholds \( z^- \) and \( z^+ \) that define three types of establishments as previously, with those with \( z \in [z^-, z^+] \) choosing \( n \). The difference with the previous analysis is that the discontinuity at \( n \) implies that \( z^+ \) is determined by
\[ \pi(w, R, z; \underline{n}, \tau)_{n = \underline{n}} = \pi(w(1 + \tau), R, z; n, \tau) \]

where \( \pi(w, R, z; \underline{n}, \tau)_{n = \underline{n}} \) are the managerial rents associated to \( n = \underline{n} \). This indifference condition results in the existence of a set of inputs that will not be demanded, \([\underline{n}, n^+]\)

where \( n^+ \) is the demand for labor services associated to \( z^+ \). The interesting observational implication of this type of policy is a “gap” in the size distribution for establishments by employment (or by capital use).\(^{14}\)

Table 8 presents the main results when \( n \) equals 15 in the undistorted case. Since mean size in Italy is much lower than in our undistorted case (about 17.1 employees), we present results for an array of implicit tax rates (20%, 35%, 50% and 65%).\(^{15}\) As the Table demonstrates, the model implies large distortionary effects emerging from restricting labor use in this way. Taking the differences in size as generated exclusively by policy, these policies determine large effects for implicit taxes that lead to differences in mean size that are smaller than the observed ones. An implicit tax of 20% leads to a reduction of aggregate output of about 2%, to a reduction in average size of about 26.5% (from 17.09 to 12.56 employees), and to a sizeable increase in the number of establishments (33.5%). These effects are of course magnified as the implicit tax rate increases. It is worth noticing also that productivity measured as output per worker drops non-trivially again, despite the fact that distorted establishments have higher measured output per worker due to the implicit tax.

A way to put these results in perspective is to ask: what it would take in the familiar one-sector growth model to reduce aggregate output in the magnitudes shown in Table 8? Assuming that the capital share, depreciation and preference parameters are the same as here, tax rates on (net) capital income of about 12-13% and of about 24-25% are needed to generate the reductions in aggregate output emerging from the implicit tax rates of 20% and 35% in Table 8.

\(^{14}\)Rauch (1991) obtains a similar result in a span-of-control framework with labor as an only input. In his model, production units are either small and belong to the “informal” sector, or sufficiently large and part of the “formal” sector.

\(^{15}\)Not surprisingly, we have verified that for a given reduction in size, this specification has stronger and more distorting effects than when the policies only affect marginal input use; for a given value of \( \hat{n} \), a given implicit tax leads to larger increases in the number of establishments, as well as to larger reductions in output and productivity measures. Consequently, relative to the case when the policy affects only marginal units, lower implicit tax rates are needed to generate given the targeted reductions in average size.
4.3 Size-Dependent Subsidies

We now explore the consequences of subsidies to “small” units, a policy of widespread acceptance across countries. We concentrate on subsidies associated to the use of capital services. If an establishment uses $k \leq k_s$, it faces a cost per unit $R(1 - s)$, whereas if it chooses $k > k_s$ it faces the rental rate $R$. Thus, this feature creates a discontinuity in the cost of capital use as in the previous case. That is, by expanding capital use beyond $k_s$, the establishment gives up the subsidy. The observable implication is a “gap” in the size distribution; that is, values of employment and/or capital use not chosen by any establishment.

To conduct quantitative experiments, we assume that the subsidies are financed by a consumption tax. This allows us to isolate the allocative effects of the subsidies, as consumption taxes in the current environment do not affect capital accumulation or occupational choice. Results are presented in Table 9 for subsidies that kick-in at $1/4$ of mean capital use. Again, and for comparison purposes, subsidy rates are found so as to generate reductions in average size of 10% and 20% respectively. The findings indicate that these policies have effects that differ in some ways from those emerging from restrictions on the size of large establishments. Quantitatively, the consequences of size-dependent subsidies can be viewed as large, despite the relatively small size of the rates and thresholds considered.

To understand how this policy operates, note that unlike all the cases studied previously, it increases directly the returns to operate small establishments. This in turn implies increases in the demand for capital and labor services by subsidized (small) establishments, as well as a reduction in the supply of labor. Across steady states, the subsidy policy leads to a higher wage rate and determines a lower output by large establishments not collecting any subsidy. The net result is a lower aggregate output and a roughly constant capital stock across steady states. Since keeping a constant capital stock in the presence of lower output is costly, consumption falls. Quantitatively, it is noteworthy that the effects created by a policy of relatively limited scope can lead to reductions in consumption across steady states in excess of 1%.

Note that unlike previous cases, output per worker increases. This is not surprising as the wage rate increase as well. But the behavior of this statistic is misleading in this case, as all other productivity measures drop. In quantitative terms, the drop in average managerial quality and output per establishment is substantial, in line with results obtained previously.
Finally, it is worth noting that dispersion in establishment size, as measured by the coefficient of variation, systematically increases as we consider higher reductions in average size; this stands in contrast with the results in previous cases. To understand this, recall that subsidies lead to more small establishments in equilibrium, a “gap” in the size distribution, while relatively large establishments contract across steady states, albeit slightly. The net effect is that the distribution by size becomes more disperse.

5 Sector-Specific Policies

In this section we investigate the consequences of policies that are sector-specific. This is a critical case to study as there are numerous cross-country examples of size-dependent policies that are applied only to certain sectors (e.g. manufacturing in India, the retail sector in France and Japan, etc.) To this end, we extend the basic framework to a two-sector model, and introduce restrictions on size in one of the sectors. We sketch the structure of this two-sector version below.

The Model  There are two goods and two sectors in the economy, 1 and 2. Sector 1 produces good 1, which is both a consumption and an investment good, while good 2, a pure consumption good, is produced in sector 2. From now on, we use good 1 as the numeraire.

The representative household maximizes

$$\sum_{t=0}^{\infty} \beta^t L_t [\theta \log(C_{1,t}/L_t) + (1-\theta) \log(C_{2,t}/L_t)],$$

where $C_{1,t}$ and $C_{2,t}$ denote the total household consumption of each good respectively. As in the one-sector case, term $L_t$ stands for the size of the household (population) and grows at a constant rate $g_L$.

A fraction $\alpha$ of household members is of type 1 and a fraction $1-\alpha$ is of type 2. A household member of type $i = 1, 2$ is endowed with $z_i$ units of managerial ability. These efficiency units are distributed with support in $[0, \bar{z}]$ with cdf $F_i(z_i)$ and density $f_i(z_i)$. Being of type 1 implies that the household member can be a worker in any sector, or a manager in sector 1. Similarly, a household member of type 2 can be a worker in any sector, or a manager in sector 2.
A manager in sector \( i = 1, 2 \) has access to the technology
\[
y_i = z_i^{1-\gamma_i} A(g(k, n))^{\gamma_i},
\]
where \( g(k, n) = k^\nu n^{1-\nu} \), and \( 0 < \nu < 1 \) and \( 0 < \gamma_i < 1 \). Thus, production requires capital \( (k) \) and labor services \( (n) \), and a sector-specific managerial input, \( z_i \). The term \( A \) is common to all units in both sectors, and grows at the aggregate rate \( g_A \). Profit maximization determines managerial rents \( \pi_1(z, w, R) \) and \( \pi_2(z, w, R, p) \), the latter being the solution to
\[
\max_{n, k} \left[ p z_2^{1-\gamma_2} A(g(k, n))^{\gamma_2} - wn - Rk \right],
\]
where \( p \) is the relative price of good 2 in terms of good 1.

The problem of the household is then to choose sequences of consumption goods 1 and 2, the fractions of household members of each type who work as managers or workers, and the amount of capital to carry over to the next period. Formally the household problem is to select \( \{C_{1,t}, C_{2,t}, K_{t+1}, \hat{z}_{1,t}, \hat{z}_{2,t}\} \) \( \infty \) to maximize (7) subject to
\[
C_{1,t} + p_t C_{2,t} + K_{t+1} = I_t(\hat{z}_{1,t}, \hat{z}_{2,t}, w_t, R_t, p_t)L_t + R_t K_t + K_t(1 - \delta),
\]
and
\[
K_0 > 0,
\]
where \( I_t(\hat{z}_{1,t}, \hat{z}_{2,t}, w_t, R_t, p_t) \) stands for the income from managerial and labor services.

Along a balanced growth path the rental rate of capital, the share of consumption of the second good in total output (in terms of good 1) and the thresholds defining occupational choice in each sector are constant. The wage rate, managerial profits and total output per capita grow at the rate \( 1 + g \equiv 1 + g_1 = (1 + g_A)^{1/(1-\gamma_1\nu)} \). The relative price grows at a rate so that managerial profits in both sectors grow at the same rate; this rate is given by \( 1 + g_p = (1 + g_1)/(1 + g_2) \), where \( (1 + g_2) \) equals \( (1 + g_A)^{1/(1-\gamma_2\nu)} \).

**Parameter Values** The notion of capital we adopt in this section is the same as in the benchmark one-sector case, and thus the corresponding notion of aggregate output is the same as well (GDP accounted for by the business sector). We define sector 2 as the Retail sector as defined in the National Income and Product Accounts (NIPA); sector 1 constitutes the rest of the economy. The share this sector has been constant as a fraction
of business GDP in the postwar period; this is an observation that justifies our choice of functional forms and focus on stationary equilibria. This share has averaged about 11.79% for the period 1960-2000.\textsuperscript{16} The values of the population growth rate and the rate of growth in output per worker are the ones corresponding to this period. Thus, \( g_L = 0.011 \) and \( g = 0.0255 \).

We treat the parameter \( \theta \) as an unknown, and choose its value so that the model reproduces the observed share of the retail sector in total output mentioned above. We then need to select values for \( \nu \), and the degrees of return to scale in both sectors, \( \gamma_1 \) and \( \gamma_2 \). To pin down these unknown parameters, we add three observations that the model is forced to match: the mean establishment size in the non-retail sector, the mean establishment size in the retail sector, and the aggregate value of the capital share.

For the first two targets, we use the 1997 U.S. Economic Census and calculate that the mean establishment size in the non-retail sector is of about 17.8 employees, while the corresponding mean value in the retail sector is of about 14.0 employees. Given the notion of capital we employ, the value for the aggregate capital share is the same as in the one-sector case (0.317).

We assume that the distributions of potential managerial ability are log-normal and the same across sectors, so that \( \log(z_i) \sim N(0, \sigma), \ i = 1, 2 \). In order to pin down \( \sigma \) and \( \alpha \), the fraction of individuals who have potential managerial abilities in sector 1, we add two observations relevant to the questions at hand. These are the dispersion in establishment size (in terms of workers), as measured by the coefficient of variation for both sectors. In the data, the distribution of establishment size is highly dispersed in both sectors, while both sectors display similar dispersion statistics. From the 1997 U.S. Economic Census, we calculate that in the non-retail sector the coefficient of variation equaled 1.63, while in the retail sector the value for this statistic was 1.57.

We set the discount factor so that the aggregate capital to output ratio in the model economy matches the observed one for the period 1960-2000. Finally, the depreciation rate corresponds to the value calibrated previously given our notion of capital.

To sum up, there are in total seven parameters that we choose in order to reproduce

\textsuperscript{16} Source: Council of Economic Advisers (2002), Table B-12. The shares corresponding to the periods 1970-2000 and 1980-2000 were, respectively, 11.84% and 11.78%.
observations. These are $\theta, \gamma_1, \gamma_2, \nu, \sigma, \alpha$ and $\beta$. Table 10 summarizes our choices.\footnote{Again, we find the model has no problem to reproduce simultaneously the targets we impose.}

**Findings** We report in Table 11 results when restrictions are applied to capital use in sector 2, and the threshold level equals mean capital in sector 2 without distortions. As before, we report results for implicit tax rates that imply reductions in average size in sector 2 of 10\% and 20\%.

Two aspects of findings are worthy of discussion. First, notice that output per worker drops by about 6.2\% (2.8\%) when mean size is reduced by 20\% (10\%). What accounts for this? This merits discussion as movements in the wage rate, which account for the fall in output per worker in the one sector case, are likely to be small as the policy is introduced on a sector that accounts only for less than 12\% of output. Note that physical output per worker in sector 2 equals

$$w^* \frac{p^* (1 - \nu)}{\gamma_2}.$$  

Therefore, while restrictions imposed on a relatively small sector affect $w$ only slightly at a point in time, changes in $p$ make output per worker to fall in the distorted sector. Quantitatively, this drop is a non-trivial one as Table 11 demonstrates. Note that this simple calculation has important implications for measurement. Two economies, one distorted and one distortion-free, under equal wage rates, will have the same output per worker if output is measured at distorted prices ($py_2/n_2$), as this measure is equal to

$$\frac{w^*}{(1 - \nu)\gamma_2}.$$  

Thus, the drop in output per worker measured in physical units that we report is equivalent to a drop in output per worker, when output is measured at undistorted prices.

Second, the increase in the relative price, $p$, is also associated to the increase in the number of establishments. Now the relevant condition for occupational choice of agents in sector 2 is $w = \pi_2(\hat{z}_2, w, R, p; k, \tau)$. While the level of $w$ changes slightly across steady states, the increase in the relative price of good 2 leads to an increase in the rents associated to the operation of an establishment in this sector. The result is the sizeable increase in the number of establishments of about 10.5\% and 23.7\% displayed in Table 11.
We emphasize that the increase in the number of small establishments in the distorted sector, as well as the fall in output per worker, emerge also naturally in the two-sector framework. Qualitatively, it is consistent with the observations pertaining to the Japanese retail sector we mentioned earlier: a large number of retail establishments per capita and a low productivity in the sector.\footnote{Quantitatively, it is not; output per worker in the retail sector is about 50\% of the U.S., and mean size in the sector is of about 6.1 employees only. Of course, size and productivity in Japan differ with respect to the United States due to several reasons beyond the type of policies we are considering.}

6 Conclusion

In this paper we analyze government policies that target production establishments of different sizes. To this end, we develop model economies in which agents differ in terms of their managerial ability, and sort themselves into managers and workers. We calibrate these economies to reproduce aggregate and cross-sectional observations from the U.S. economy, and then introduce different government policies that depend on the size of production units via input use, either for the economy as a whole or at the sectorial level. Our discipline to evaluate the quantitative consequences of these policies is to find either the implicit taxes or subsidies in each case that achieve \textit{given} reductions in average size.

We conclude the paper by mentioning two important issues we abstracted from. The first one is that our analysis does not permit those agents who become managers to switch sectors whenever policies are sector specific. A natural conjecture is that when managers can move across sectors, or more generally, can switch sectors \textit{and} accumulate sector specific skills, the policies in question will be significantly more costly in terms of productivity and welfare.

The second one relates to the interplay between restrictions on size and technical progress. If the emergence of new technologies allows the operation of larger establishments, as it seems to be the case in the retail sector, the policies we study are again likely to be more costly than in our current analysis. More generally, we know that technological change in the production of new equipment has been remarkable in the postwar United States. This has resulted in cheaper, more efficient equipment and triggered more investment in these capital goods. Greenwood, Hercowitz, and Krusell (1997) document that the relative price of equipment declined at an annual average rate of 3.2\% between 1954 and 1990, and that
such investment-specific technological progress accounts for about 60% of postwar growth in output per hour worked. Indeed, investment-specific technological change has accelerated recently. Cummins and Violante (2002) estimate an aggregate index of investment specific technological change for the U.S. economy, and show that this index grows at an annual rate of 4% for the 1947-2000 period, and that its growth accelerates in the last two decades (about 6% in the 1990’s). The consequence of this acceleration would be an increase in optimal size of establishments and thus, higher welfare costs associated to restrictions on size that depend on capital use.$^{19}$

The full investigation of these issues requires considering more elaborated model economies than the simple ones studied here. We leave these extensions for future work.

$^{19}$Greenwood and Yorukoglu (1997) study a model of adoption of new technologies when technical change is investment specific. In their model, as technical change accelerates optimal size increases as well.
7 Appendix: Size-Dependent Policies Across Countries

In this Appendix we document key examples of policies that affect or restrict the size of firms and establishments across countries. These policies are present both in developed and underdeveloped countries and can be economy-wide or sector-specific. The policy provisions in question provide protection to small production units either via subsidies or promotion schemes, or through restrictions on the size of large units. We document few prominent cases where “size” for policy purposes is defined in terms of the use of labor or other inputs like capital and land services.

7.1 Manufacturing: India

India has a long tradition of protection for small businesses or Small Scale Industries (SSI), and given the scope and persistence of the regulations, it is probably the most striking case of size restrictions nowadays. Indeed, authors have attributed the poor economic performance of the manufacturing sector in India, and the disparities between the recent development patterns of India and China, to policies of this sort. Moreover, the liberalization reforms that started in 1991 did not affect fundamentally the policies in question.

The protection of small businesses started with the Industries Development and Regulation Act of 1951, which defined what constituted a small enterprise for policy purposes. Currently, there is a vast number of complex provisions in place. These policies are now under the administration and control of the recently created Ministry of Small Scale Industries, and are applied to the manufacturing sector. Among the policy instruments, is the Small-Scale Reservation Policy that we discuss below.

Since 1951, what constitutes a small business for policy purposes depends on a threshold level of cumulative investment that has been increasing with inflation. By 1997, the level was Rs. 30 million in plants and machinery (about US$ 690,000). Interestingly, the cutoff level was revised downwards in 1999 to Rs. 10 million (US$ 230,000), and continues at this level today. Currently, the small sector is not necessarily small: it comprises about 95% of all industrial units, accounts for about 40% of value added in the manufacturing sector and

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for about 6.9% of GDP.\footnote{Source: Ministry of Small Scale Industries (2003).} Following Mohan (2002), the long and evolving list of policy provisions in place can be classified in 4 groups.

1. **Fiscal Incentives:** the provisions of the law determine that units below the small scale level are exempt, partially or totally, from excise and sales taxes and duties on their products and items purchased. According to Little, Mazumdar, and Page (1987), Table 3-1, using the rates prevailing in 1980, the exemption rates associated only to excise taxes, ranged from 4.8% to 25.1%. A subsequent tax reform made these magnitudes more uniform across product lines.

2. **Credit Support:** Prior to economic reforms, 40% of all bank credit had to be allocated to priority sectors (SSI, agriculture, etc.) with a minimum of 15% to SSI at government dictated interest rates. This policy was applied to each commercial bank in the country. The reservation of credit has continued unchanged after the process of economic reforms, but the interest rates have been deregulated. According to Mohan (2002), this has led to subsequent policy measures aimed at reducing the effects of higher interest rates on loans to SSI’s.

3. **Promotion Programs:** This encompasses preferences in procurement, provision of managerial and technical assistance, as well as a myriad of assistance programs at the state level. In terms of procurement, since the 1960’s the Federal government sets aside a set of manufactured products that can only be procured from SSI’s. This list contains currently 358 products. In addition, there is a price preference (15%) given to SSI’s in procurement tenders. As previously, note that this discourages the expansion or emergence of businesses beyond the specified limits.

4. **Reservation Policy:** This is the most notorious and known aspect of the policies. The reservation policy began in 1967, when the government set aside a group of manufactured products to be produced exclusively by SSI’s. After the date of reservation, no new large units were allowed to operate. Existing units were allowed to operate only at frozen capacity at the reservation date.\footnote{New large units were later allowed to operate if they export at least 50% of their production.} While the set of products reserved was initially small (47), it grew to 177 products in 1974, 504 in 1978, and to 847 product types in 1989. By 1987-88,
reserved products accounted for about 29% of total output of small scale industries (Mohan (2002), Table 6.13). This implies that with a share of manufacturing in total output of about 21% by then and a share of SSI in manufacturing of approximately 45%, approximately 2.5-2.7% of GDP was accounted for by the production of reserved products. This is of course, an estimate of the size of the reserved sector under the reservation policy when output is measured at distorted prices.

These policies clearly discourages the expansion or emergence of businesses beyond the specified limits; any expansion implies the loss of these benefits. After more than 10 years of economic reforms, the reservation policy is still in place, with only a trivial change in the number of reserved products; currently the number of reserved products is 799, while it was 836 in prior to the reforms.

7.2 Retail Sector I: Japan

Japan offers a unique and rather old case of protection of small retail shops. Owners of these shops constitute a strong pressure group, and as a result there exists national legislation that has aimed directly in the past, and indirectly in its present form, to protect and benefit them.

The origins of the regulations of large retail stores goes back to 1937, with the first "Department Store Law" enacted in reaction to complaints from small shop owners due to the expansion of large department stores. This law was eliminated in 1947 under the American administration, but was brought back under the same name in 1956. This law stipulated a special procedure in order to get a license for the expansion of existing retail businesses, or the opening of new ones, beyond 1,500 square meters.

The 1956 law applied to department stores, and thus other retail formats such as supermarkets, discount stores, etc., were not covered. As a result, the subsequent growth of these stores constituted a source of complaints for the retail lobby. Furthermore, the law focused on retail businesses of the department store category. This opened up a loophole under which large department stores were divided into separate business entities within the same building, each of them not exceeding 1500 sq. mts (Larke (1994)). The complaints that this generated led to a major revision of the law, which took place in 1974. The new legislation, called Large Scale Retail Store Law, now focused on retail stores, closing thereby
the loophole just described, and its scope was extended to include retail formats other than traditional department stores. The legislation specified an application process to get a license for retail stores above 3,000 sq. mts. in big cities, and 1,500 sq. mts. everywhere else.\(^{23}\)

In 1979 the law was reformed. The reform expanded severely the scope of the regulations under pressure of the retail lobby. It created two types of stores subject to restrictions, a model that continued until recently. Type-1 stores were those larger than 1,500 sq. mts (3,000 sq. meters in large cities), while Type-2 stores covered a group of a substantially small size: between 500 sq. meters 1,500 sq. meters. Applications for stores of Type-1 were made to the Ministry of Trade and Industry (MITI), while applications for Type-2 were dealt at the local (prefectural) level.

The implementation of the law was altered in 1982, as the MITI introduced changes pertaining to stores of the first type. First, it provided local governments authority to restrict the opening of new stores in certain regions. Second, it created a new stage in the application process. This stage called for a consensus of interested parties, including those potentially affected by the opening (small, traditional stores). Notably, without consensus the whole process could not begin. The natural strategy of affected parties was not to provide consensus, as Larke (1994), pp. 112, explains. As a result, most of the successful proposals for new stores in the 1980’s took several years to complete.

By the mid-eighties, as a result of the law and the norms issued by the MITI governing its implementation, the process of obtaining approval for a new store at the Type 1 level was a long and costly one. It required a minimum of seven different stages, and a maximum of 16. The first stage was a critical one, the local consensus stage, which could force the abandonment of the plans altogether. At many of these stages, the plans for the proposed new store could be stopped, or business plans could be forced to change by those negatively affected. It is worth noting that, most likely due to the increased severity and complexity of the regulations, the number of applications of the first type fell from about 399 in 1974 to about 157 in 1986; for Type-2 stores, the number of application fell from 1029 in 1979 to about 369 in 1986.\(^{24}\) To put these figures in perspective, it is worth emphasizing that the

\(^{23}\)An application had to specify at a minimum the proposed floor space, opening date, hours of operation, and the number of days in which the store would be closed during a year. See Ito (1992) for details. By the early nineties, the implementation of the law also set specified upper limits regarding closing times (7PM), and a minimum number of annual closed days (44).

\(^{24}\)Source: Larke (1994).
size of the Japanese population is of about 120 million, and that the Japanese economy grew at an annualized rate of about 3.6% from 1974 to 1985.\textsuperscript{25}

In 1992 the law was significantly relaxed for the first time. The most important change was the simplification of the application process, with the elimination of the first (consensus) stage, and a maximum of a year for the whole application process. Still, nonetheless, the lobby of small retailers retained a critical influence in the application process. Other changes included the increase in the lower limit for type 1 stores to 3000 sq. mts (6,000 sq. mts in big cities).

In 2000, the Large Scale Retail Location Law replaced the previous one. The new law requires the approval for stores larger than 1000 sq. meters, while the parties affected by the opening a new store are still a critical part of the application process. The new legislation differs from the old one in two dimensions. First, all decisions are taken at the local level. Second, the protection of small retail is no longer an explicit objective of the legislation. The decision criteria now takes into account environmental factors (noise, congestion, etc.). It can be argued that the new legislation is even more restrictive than before. First, the limit on size now kicks in at 1,000 square meters. Second, as McKinsey Global Institute (2000) discusses, local governments are unlikely to see net benefits from a more competitive retail environment; these receive only a small share of their revenues from taxation of businesses as their operations are mostly financed from transfers from the Federal government.

\section*{7.3 Retail Sector II: France}

Prior to 1974, the opening of a store or the expansion of an existing one in France required only a building permit. In December 1973, the French Parliament approved the \textit{"Loi d'Orientation du Commerce et de l'Artisanat"} or the Loi Royer. The law had the explicit objective of protecting owners of small retail shops against the 'disordered' growth of new forms of distribution (Article 1). Among several measures, the law created an extra step, in addition to the standard building permit, in order to open a new retail outlet or expand an existing one above a nationally pre-specified limit.

Under the Loi Royer, any new store larger than 1,500 sq. meters (1000 sq. meters in cities with less than 40,000 people) requires the approval of a regional zoning committee

\textsuperscript{25}McCraw and O’Brien (1986) make a similar point.
created after the law. The same rules also apply to the expansion of existing stores, and the conversion of existing buildings into retail space. Interestingly, like in Japan under the Large Scale Retail Store Law, directly affected parties (owners of small retail shops and craftsmen) are represented in these committees. If a proposal is rejected, there is an appeal possibility at the national level. At this level, a Ministry, advised by a national zoning commission, can overturn the decisions of the regional committee.

Bertrand and Kramarz (2002) argue that the application process is a costly one, and show that a non-trivial fraction of proposals were effectively rejected by the regional committees. The mean approval rate across French departments from 1975 to 1998 was 42 percent, and projects for relatively large stores faced a lower probability of acceptance than small ones. They also show that there was variation across the country in terms of approvals; some departments in this period had approval rates as low as 10%.

7.4 Employment Protection in OECD countries

Employment protection legislation in several developed countries contains provisions that depend on the size of firms and/or establishments. This is present in many aspects of the prevailing provisions (e.g. rules regarding fixed term contracts, redundancy procedures, pre-notification periods, severance payments and requirements for collective dismissals) for countries like Italy, Germany, France and Spain. In the case of the United States, despite the absence of employment protection legislation present in other OECD countries, there is legislation related to employment that depends on size. The norms in question are contained in the Civil Rights Act of 1991 and in the American with Disabilities Act of 1990.

The case of employment protection legislation in Italy is interesting to describe in detail, as it clearly shows how the policy provisions that depend on size actually operate. In a nutshell, firms with more than 15 employees face employment protection legislation that differs in many ways with the legislation faced by smaller firms. Within the Italian institutional setting, five type of regulations depend on firm’s size: employment protection, mandatory quotas on hiring, firm level rights to organize union related institutions, firm safety standards

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26 They hold 9 out of 20 votes, and decisions are adopted by simple majority rule.
27 According to Bertrand and Kramarz (2002), the law has become more strict in recent years, with a reduction in the threshold levels and with a stronger majority requirement for the approval of a project.
28 See Bertola, Boeri, and Cazes (1999) for an extensive documentation.
29 We follow Garibaldi, Pacelli, and Borgarello (2003) in the description of the Italian institutional setting.
and collective dismissal rules.

The key institutional constraint is about individual dismissal rules (Article 18 of the labor code). Individual dismissals must be supported by a just cause, and workers have the right to appeal firm initiated dismissals. Whenever a judge rules a dismissal unfair, workers are entitled to a compensation that hinges on firms size. Firms employing less than 15 employees must compensate the (unfairly) dismissed worker and pay a severance payment ranging from 2.5 to 6 months. Firms employing 15 workers or more, must rehire the worker and pay a compensation for the foregone wages from the dismissal’s date to the date of the ruling.

It is worth noting how the law computes the threshold of 15 employees for dismissals. First, the 15 employees refer to establishments rather than firms. In addition, part-time workers should be included in proportion to their actual time and all temporary contracts should be counted. Apprentices and temporary workers below nine months are not taken into account.

Regarding hiring preferences, firms employing more than 10 workers are obliged to hire disadvantaged workers; that is, workers that are officially registered as long-term unemployed. Furthermore, as of 1999, firms employing more than 15 workers must employ disabled workers.

Finally, norms governing the activity of unions apply only to firms employing more than 15 workers. These norms entitle workers to establish a firm level institution that has the right to call union meetings, establish referenda, and post union related posters inside the workplace. Likewise, firms with more than 15 employees have the right to vote for a worker representative for safety related issues.

7.5 Subsidies to Small Units

Government policies that support small and medium size enterprises (SMEs), either firms or establishments, are very common, if not universal, both in developing and developed countries. The particular attention to SMEs is perhaps justified by their sheer number: they represent, for example, between 96% and 99% of the total number of enterprises in the whole economy and between 60 to 70% of total manufacturing employment in most OECD countries.\footnote{See O.E.C.D. (2002). SMEs are usually defined enterprises with less than 250 employees, although the U.S. definition is less than 500.} Furthermore, SMEs are responsible for the bulk of new businesses and gross
Policies that affect SMEs can be grouped in two categories. The first group consists of policies that promote entrepreneurship and reduce entry costs. The second group encompasses size-dependent policies that provide *special provisions* for SMEs.

Korea provides an illustrative example for the wide range of policies in this second group:

1. **Financial Subsidies:** Korean Credit Guarantee Fund (KCGF) and Korea Technology Credit Guarantee Fund (KOTEC) provide credit guarantees to SMEs that are otherwise ineligible for regular bank loans. SMEs can also borrow directly from Small Business Corporation (SBC) at low interest rate the purpose of start-up, investment, automation, and commercialization of new technologies.\(^{32}\) Furthermore, all commercial, regional, and foreign banks are required to allocate a certain proportion of their loans to SMEs.\(^{33}\)

2. **Special Tax Treatment:** Newly created SMEs receive a 50% reduction of income and property tax payments up to five years and are exempt from registration and transaction taxes for two years. There is also a special 20% tax credit to small firms in the manufacturing sector. SMEs are also allowed to deduct 50% more for depreciation than larger firms.\(^{34}\)

3. **Other policies:** Like the Indian case discussed above, under the Small Business Coordination Act of 1961, certain sub-sectors are reserved for SMEs, and the entry or expansion of large-scale enterprises requires government approval. Furthermore, under the SMEs Products Procurement Act of 1981 the government agencies are obliged to purchase certain products from SMEs. Both programs were reduced in their scope, but not completely eliminated, during the economic liberalization of the 1990s. There are also several programs that try to lure employees to SMEs, e.g. an employee who works for SMEs for more than 10 years is preferentially granted the right to purchase public condominiums.

Two observations make the Korean SME policies of particular relevance. First, financial subsidies to and special tax treatment of SMEs are very common. Both developed and developing, provide special financing arrangements to SMEs, either in the form of loan grantees or interest rate subsidies. Argentina’s Regimen de Bonificacion de Tasas (Interest Rate Subsidies) is a typical example. According to this program the national government covers up to 8 percentage points of annualized nominal interest rate established by the financial insti-

\(^{31}\)Beck, Demirguc-Kunt, and Levine (2005) show that although a large SME sector is a characteristic of fast growing economies, the relationship is not causal.

\(^{32}\)See [http://www.smba.go.kr/main/english/sub5/sub05_1.jsp](http://www.smba.go.kr/main/english/sub5/sub05_1.jsp)

\(^{33}\)See Kim (2004).

tution. The Central Bank of Argentina (BCRA) is responsible for the reimbursement of the subsidy amount to the financial institutions. The subsidy includes activities such as acquisition of new capital goods of national origin, working capital, export financing or setting up of new enterprises/establishments.\textsuperscript{35} Japan is another example where government financial institutions, Japan Finance Corporation for Small and Medium Enterprises (JASME), National Life Finance Corporation (NLFC), and Shoko Chukin Bank, provide both direct, low interest, uncollateralized loans as well as credit grantees to SMEs.\textsuperscript{36}

In similar fashion, most OECD countries have lower corporate tax rates for SMEs. These countries include Belgium, Canada, France, Germany, Ireland, Japan, Korea, Luxembourg, Mexico, the Netherlands, Portugal, Spain, the UK, and the U.S. Several countries also provide tax incentives for investment, like tax credits and more generous depreciation allowances, that are specific to SMEs.\textsuperscript{37}

Second, Korea is by no means alone in the extent and multiplicity of government policies that support small establishments. Argentina is another good example for myriad of specially designed programs to offer training and technical assistance as well as financial support to small and medium-sized enterprises. According to the recently created Secretariat of Small and Medium-Sized Enterprises (Secretaría de Pequeñas y Medianas Empresas, SEPyME), a part of the Ministry of Economy, Argentina has approximately 300 programs and lines of credit to support SMEs, implemented by national, provincial, and municipal governments as well as non-government organizations for SME programs.\textsuperscript{38}

\textsuperscript{35}Source: Secretaría de Pequeñas y Medianas Empresas y Desarrollo Regional (SePYME), \url{www.sepyme.gov.ar}.
\textsuperscript{36}Ministry of Economy, Trade and Industry (2004).
\textsuperscript{38}See World Bank (2000).
References


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### Table 1: Parameter Values

<table>
<thead>
<tr>
<th>Parameter</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciation Rate ($\delta$)</td>
<td>0.040</td>
</tr>
<tr>
<td>Importance of Capital ($\nu$)</td>
<td>0.388</td>
</tr>
<tr>
<td>Returns to Scale ($\gamma$)</td>
<td>0.817</td>
</tr>
<tr>
<td>Dispersion in Managerial Ability ($\sigma$)</td>
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<tr>
<td>Discount Factor ($\beta$)</td>
<td>0.9357</td>
</tr>
<tr>
<td>Population Growth Rate ($g_L$)</td>
<td>0.0110</td>
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<tr>
<td>Productivity Growth Rate ($g$)</td>
<td>0.0255</td>
</tr>
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### Table 2: Targets

<table>
<thead>
<tr>
<th>Statistic</th>
<th>Data</th>
<th>Model</th>
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</thead>
<tbody>
<tr>
<td>Mean Size</td>
<td>17.087</td>
<td>17.090</td>
</tr>
<tr>
<td>Coeff. of Variation</td>
<td>1.620</td>
<td>1.620</td>
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<tr>
<td>Aggregate Capital Share</td>
<td>0.317</td>
<td>0.317</td>
</tr>
<tr>
<td>Capital Output Ratio</td>
<td>2.325</td>
<td>2.331</td>
</tr>
</tbody>
</table>

Note: This Table reports the performance of the basic model when the parameters $\nu$, $\gamma$, $\sigma$ and $\beta$ are selected to best reproduce the reported features of the data.
Table 3: Aggregate and Productivity Effects

<table>
<thead>
<tr>
<th>Statistic</th>
<th>Benchmark</th>
<th>10% Reduction in Average Size</th>
<th>20% Reduction in Average Size</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aggregate Output</td>
<td>100.00</td>
<td>95.13</td>
<td>90.74</td>
</tr>
<tr>
<td>Capital</td>
<td>100.00</td>
<td>86.28</td>
<td>76.82</td>
</tr>
<tr>
<td>Consumption</td>
<td>100.00</td>
<td>97.06</td>
<td>93.77</td>
</tr>
<tr>
<td>Output per Worker</td>
<td>100.00</td>
<td>95.79</td>
<td>91.99</td>
</tr>
<tr>
<td>Output per Establishment</td>
<td>100.00</td>
<td>85.80</td>
<td>73.66</td>
</tr>
<tr>
<td>Output per Efficiency Units</td>
<td>100.00</td>
<td>93.65</td>
<td>88.06</td>
</tr>
<tr>
<td>Average Managerial Quality</td>
<td>100.00</td>
<td>91.67</td>
<td>83.74</td>
</tr>
<tr>
<td>Number of Establishments</td>
<td>100.00</td>
<td>110.87</td>
<td>123.19</td>
</tr>
<tr>
<td>Implicit Tax (%)</td>
<td>-</td>
<td>18.0</td>
<td>45.0</td>
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<tr>
<td>Welfare Cost (%)</td>
<td>-</td>
<td>0.55</td>
<td>2.21</td>
</tr>
</tbody>
</table>

Note: This Table reports aggregate and productivity effects of restricting the size of large establishments via implicit taxes on the use of capital. The implicit tax $\tau$ is found in order to generate a 10% and 20% reduction in the average size of establishments. The threshold $k$ equals mean capital use in the undistorted case.

Table 4: Output Accounted for by Managers of Different Ability (%)

<table>
<thead>
<tr>
<th>Economy</th>
<th>Lowest 20%</th>
<th>Next 20%</th>
<th>Next 20%</th>
<th>Next 20%</th>
<th>Upper 20%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Benchmark</td>
<td>3.68</td>
<td>5.33</td>
<td>8.41</td>
<td>15.93</td>
<td>66.65</td>
</tr>
<tr>
<td>10% Reduction</td>
<td>4.17</td>
<td>6.09</td>
<td>9.66</td>
<td>18.29</td>
<td>61.79</td>
</tr>
<tr>
<td>Average Size</td>
<td>4.61</td>
<td>6.81</td>
<td>11.02</td>
<td>21.06</td>
<td>56.51</td>
</tr>
</tbody>
</table>

Note: This Table reports the fraction of output accounted for by managers at different quintiles of the distribution of managerial ability, with and without restrictions on capital use on large establishments. The implicit tax $\tau$ is found in order to generate a 10% and 20% reduction in the average size of establishments. The threshold $k$ equals mean capital use in the undistorted case.
Table 5: Size Distribution Effects

<table>
<thead>
<tr>
<th>Statistic</th>
<th>Benchmark</th>
<th>10% Reduction in Average Size</th>
<th>20% Reduction in Average Size</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mean Size</td>
<td>17.09</td>
<td>15.31</td>
<td>13.68</td>
</tr>
<tr>
<td>Coeff. Variation</td>
<td>1.62</td>
<td>1.52</td>
<td>1.32</td>
</tr>
<tr>
<td>Median Size</td>
<td>7.02</td>
<td>7.24</td>
<td>7.31</td>
</tr>
<tr>
<td>% Distorted ($k \geq k$)</td>
<td>22.90</td>
<td>23.57</td>
<td>23.39</td>
</tr>
<tr>
<td>% Distorted ($k &gt; k$)</td>
<td>22.90</td>
<td>15.41</td>
<td>8.68</td>
</tr>
</tbody>
</table>

Note: This Table reports the consequences on the distribution of establishment size, measured by the number of employees, associated to restricting the size of large establishments via implicit taxes on the use of capital. The implicit tax $\tau$ is found in order to generate a 10% and 20% reduction in the average size of establishments. The threshold $k$ equals mean capital use in the undistorted case.

Table 6: The Role of Returns to Scale ($\gamma$) (% reduction in output - 20% reduction in mean size)

<table>
<thead>
<tr>
<th>Value of $\gamma$</th>
<th>No Adjustment</th>
<th>Capital Share Adjustment</th>
<th>Capital Share and Mean Size Adjustment</th>
</tr>
</thead>
<tbody>
<tr>
<td>$\gamma=0.85$</td>
<td>7.9</td>
<td>7.6</td>
<td>7.1</td>
</tr>
<tr>
<td>$\gamma=0.9$</td>
<td>5.2</td>
<td>4.9</td>
<td>4.4</td>
</tr>
</tbody>
</table>

Note: This Table reports the effects on output implied by restrictions on capital use for different values of the return to scale parameter $\gamma$. Results are reported for the case of $\gamma = 0.85$ and $\gamma=0.90$. The implicit tax $\tau$ is found in order to generate a 20% reduction in the average size of establishments. The threshold $k$ equals mean capital use in the undistorted case in each case.
### Table 7: Size-Dependent Restrictions on Labor Use

<table>
<thead>
<tr>
<th>Statistic</th>
<th>Benchmark</th>
<th>10% Reduction in Average Size</th>
<th>20% Reduction in Average Size</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aggr. Output</td>
<td>100.00</td>
<td>99.82</td>
<td>99.19</td>
</tr>
<tr>
<td>Capital</td>
<td>100.00</td>
<td>99.82</td>
<td>99.19</td>
</tr>
<tr>
<td>Consumption</td>
<td>100.00</td>
<td>99.82</td>
<td>99.20</td>
</tr>
<tr>
<td>Output per Worker</td>
<td>100.00</td>
<td>97.47</td>
<td>95.06</td>
</tr>
<tr>
<td>Output per Establishment</td>
<td>100.00</td>
<td>90.03</td>
<td>80.52</td>
</tr>
<tr>
<td>Output per Efficiency Units</td>
<td>100.00</td>
<td>98.36</td>
<td>96.28</td>
</tr>
<tr>
<td>Average Managerial Quality</td>
<td>100.00</td>
<td>91.67</td>
<td>83.74</td>
</tr>
<tr>
<td>Number of Establishments</td>
<td>100.00</td>
<td>110.87</td>
<td>123.19</td>
</tr>
<tr>
<td>Median Size</td>
<td>7.02</td>
<td>7.19</td>
<td>7.26</td>
</tr>
<tr>
<td>Coeff. Variation</td>
<td>1.62</td>
<td>1.54</td>
<td>1.42</td>
</tr>
<tr>
<td>Implicit Tax (%)</td>
<td>-</td>
<td>7.30</td>
<td>16.00</td>
</tr>
<tr>
<td>Welfare Cost (%)</td>
<td>-</td>
<td>0.13</td>
<td>0.66</td>
</tr>
</tbody>
</table>

Note: This Table reports the consequences of restricting the size of large establishments via implicit taxes on the use of labor services. The implicit tax $\tau$ is found in order to generate a 10% and 20% reduction in the average size of establishments. The threshold $n$ equals mean labor use in the undistorted case.

### Table 8: The “Italy” Case ($n = 15$)

<table>
<thead>
<tr>
<th>Statistic</th>
<th>Benchmark</th>
<th>20% Tax</th>
<th>35% Tax</th>
<th>50% Tax</th>
<th>65% Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aggr. Output</td>
<td>100.00</td>
<td>98.09</td>
<td>95.56</td>
<td>93.04</td>
<td>90.80</td>
</tr>
<tr>
<td>Mean Size</td>
<td>17.09</td>
<td>12.56</td>
<td>10.82</td>
<td>10.01</td>
<td>9.39</td>
</tr>
<tr>
<td>Coeff. Variation</td>
<td>1.62</td>
<td>1.49</td>
<td>1.23</td>
<td>0.95</td>
<td>0.71</td>
</tr>
<tr>
<td>Output per Worker</td>
<td>100.00</td>
<td>93.82</td>
<td>90.82</td>
<td>88.93</td>
<td>87.89</td>
</tr>
<tr>
<td>Number of Establishments</td>
<td>100.00</td>
<td>133.51</td>
<td>153.08</td>
<td>164.31</td>
<td>174.09</td>
</tr>
<tr>
<td>Welfare Cost (%)</td>
<td>1.60</td>
<td>3.83</td>
<td>6.18</td>
<td>8.37</td>
<td></td>
</tr>
</tbody>
</table>

Note: This Table reports the consequences of restricting the size of large establishments via implicit taxes on the use of labor services, when $n = 15$ as in the case of Italian size-dependent regulations. Differently from the cases analyzed before, if an establishment chooses labor services beyond $n$, marginal and inframarginal units of labor are subject to the implicit tax.
### Table 9: Size-Dependent Subsidies

<table>
<thead>
<tr>
<th>Statistic</th>
<th>Benchmark</th>
<th>10% Reduction in Average Size</th>
<th>20% Reduction in Average Size</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aggr. Output</td>
<td>100.00</td>
<td>99.79</td>
<td>99.63</td>
</tr>
<tr>
<td>Capital</td>
<td>100.00</td>
<td>99.65</td>
<td>99.99</td>
</tr>
<tr>
<td>Consumption</td>
<td>100.00</td>
<td>99.29</td>
<td>98.15</td>
</tr>
<tr>
<td>Output per Worker</td>
<td>100.00</td>
<td>100.42</td>
<td>101.00</td>
</tr>
<tr>
<td>Output per Establishment</td>
<td>100.00</td>
<td>90.00</td>
<td>80.88</td>
</tr>
<tr>
<td>Average Managerial Quality</td>
<td>100.00</td>
<td>91.67</td>
<td>83.74</td>
</tr>
<tr>
<td>Number of Establishments</td>
<td>100.00</td>
<td>110.87</td>
<td>123.19</td>
</tr>
<tr>
<td>Median Size</td>
<td>7.02</td>
<td>4.85</td>
<td>4.55</td>
</tr>
<tr>
<td>Coeff. Variation</td>
<td>1.62</td>
<td>1.72</td>
<td>1.81</td>
</tr>
<tr>
<td>% Distorted ($k \leq \bar{k}$)</td>
<td>26.30</td>
<td>58.99</td>
<td>69.36</td>
</tr>
<tr>
<td>% Distorted ($k &lt; \bar{k}$)</td>
<td>26.30</td>
<td>22.32</td>
<td>15.56</td>
</tr>
<tr>
<td>Subsidy (%)</td>
<td>-</td>
<td>9.00</td>
<td>18.00</td>
</tr>
<tr>
<td>Welfare Cost (%)</td>
<td>-</td>
<td>0.64</td>
<td>1.85</td>
</tr>
</tbody>
</table>

Note: This Table reports the consequences of subsidizing capital use in small establishments. The subsidy rate is found in order to generate a 10% and 20% reduction in the average size of establishments, and it is financed via a consumption tax. The threshold $\bar{k}$ equals 1/4 mean capital use in the undistorted case.

### Table 10: Parameter Values

<table>
<thead>
<tr>
<th>Parameter</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciation Rate ($\delta$)</td>
<td>0.040</td>
</tr>
<tr>
<td>Share of Good 1 in Utility ($\theta$)</td>
<td>0.8564</td>
</tr>
<tr>
<td>Importance of Capital ($\nu$)</td>
<td>0.3856</td>
</tr>
<tr>
<td>Returns to Scale Sector 1 ($\gamma_1$)</td>
<td>0.8255</td>
</tr>
<tr>
<td>Returns to Scale Sector 2 ($\gamma_2$)</td>
<td>0.7960</td>
</tr>
<tr>
<td>Fraction Type 1 ($\alpha$)</td>
<td>0.8530</td>
</tr>
<tr>
<td>Dispersion in Managerial Ability ($\sigma$)</td>
<td>2.9615</td>
</tr>
<tr>
<td>Discount Factor ($\beta$)</td>
<td>0.9357</td>
</tr>
<tr>
<td>Population Growth Rate ($g_L$)</td>
<td>0.0110</td>
</tr>
<tr>
<td>Productivity Growth Rate ($g$)</td>
<td>0.0255</td>
</tr>
</tbody>
</table>

Note: This Table reports the values of parameters in the two-sector case economy. The values of $\theta$, $\nu$, $\gamma_1$, $\gamma_2$, $\beta$, $\alpha$ and $\sigma$ are selected so that they reproduce the reported features of the data.
Table 11: Restrictions on Capital Use in Two-Sector Case

<table>
<thead>
<tr>
<th>Statistic</th>
<th>Benchmark</th>
<th>10% Reduction in Average Size</th>
<th>20% Reduction in Average Size</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aggr. Output (*)</td>
<td>100.00</td>
<td>99.54</td>
<td>99.11</td>
</tr>
<tr>
<td>Output Sector 2</td>
<td>100.00</td>
<td>97.21</td>
<td>93.81</td>
</tr>
<tr>
<td>Relative Price (p)</td>
<td>100.00</td>
<td>103.05</td>
<td>106.62</td>
</tr>
<tr>
<td>Output per Worker Sector 2</td>
<td>100.00</td>
<td>97.04</td>
<td>94.05</td>
</tr>
<tr>
<td>Number of Establishments Sector 2</td>
<td>100.00</td>
<td>110.53</td>
<td>123.68</td>
</tr>
<tr>
<td>Median Size Sector 2</td>
<td>6.05</td>
<td>6.11</td>
<td>6.28</td>
</tr>
<tr>
<td>Coeff. Variation Sector 2</td>
<td>1.57</td>
<td>1.49</td>
<td>1.31</td>
</tr>
<tr>
<td>Implicit Tax (%)</td>
<td>-</td>
<td>18.25</td>
<td>49.75</td>
</tr>
</tbody>
</table>

(*): At benchmark (undistorted) prices.

Note: This Table reports the consequences of restricting the size of large establishments in the two-sector model, when this is done via implicit taxes on capital use in Sector 2. The implicit tax $\tau$ is found in order to generate a 10% and 20% reduction in the average size of establishments in Sector 2. The threshold $k$ equals mean capital use in sector 2 in the undistorted case.
Figure 1 --- Size Distribution of Establishments

Data

Model
Figure 2 --- The Effects of Restrictions on Size