Firm Size, Efficiency and Employment Revisited: A Review Article

Felix R. FitzRoy

Whether small business can "help countries compete" as many American commentators believe, or whether increasing firm-size is required for success in global markets, as much European policy assumes, is still a question under intense debate. While the terms of the debate have been persuasively challenged by Howard (1990) who argues that "The real issue isn't size; it's industrial organization" (p. 88), the popular American view of small business has been most comprehensively challenged by Brown, Hamilton and Medoff (1990). However, we find that both their analysis and evidence are flawed in a number of important respects to be developed next, and then we shall go back to the broader issues raised by Howard (1990), Best (1990), Loveman and Sengenberger (1991), and earlier by FitzRoy (1989 and 1990).

Brown, Hamilton and Medoff (henceforth BHM) start by disputing the growing importance of small firm employment found by many writers. They find stable or declining small-business employment shares in the U.S. However, Sengenberger, Loveman and Piore (1990) find growing small-business shares in many countries in recent years, including a rise of 7.5% in manufacturing employment by U.S. firms with less than 100 employees from 1980—86, compared to a decline of 10.8% in firms with over 500 workers (Howard, p. 90).

BHM devote much space to the evidence that large employers seem to pay substantially higher wages and fringe benefits, even after controlling for the higher levels of education, training and unionization found on average in larger firms. An obvious candidate for explaining this differential would seem to be intangible benefits such as job satisfaction, but this is rejected by BHM because of lower quit rates and more applicants per vacancy in large firms. They admit that the latter variable may reflect "an employer's visibility in the local labour market" (p. 58), and make no mention of survey evidence on the greater incidence of strikes and worker dissatisfaction in large organizations in various countries.

Matters are complicated by the strong correlation of unionization with employer size in the U.S. and elsewhere. Organization of labour, including formalized grievance procedures, may encourage the articulation of complaints at work, and increase the perception of potential gain from overt conflict. Large employers are also easier targets in some ways. An important point neglected by BHM is the increased incidence of deferred benefits including seniority and steeper age-earnings profiles under collective bargaining. This could explain lower quit rates in larger firms and unionized work forces, in spite of reduced job-satisfaction under more regimented and bureacratic working conditions found by Duncan and Stafford (1982) and others. Like BHM, Freeman and Medoff (1984) also made the erroneous argument from lower quit rates under unionization to discount evidence on job-dissatisfaction, without allowing for the immobilizing effect of deferred benefits. Internal mobility also provides an alternative to quitting in large organizations.

Since large employers often have multiple vacancies, it is worthwhile for them to advertise and generate job-queues from which they can select most favoured applicants. Many individual characteristics such as looks or attractive personality traits are not controlled in earnings data, so it is quite plausible that lucky applicants to large organizations receive rents to attributes that are

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Department of Economics
University of St. Andrews
St. Andrews
Scotland KY16 9AL
U.K.

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observed continually by their bosses or colleagues but not by distant econometricians.

Another serious weakness in BHM is their casual dismissal of the old idea that large-firm employees share monopoly rents. There is in fact a large body of evidence ignored by BHM, that persistent and stable wage differentials across industries are related to industry concentration, firm size, capital intensity and profitability. Katz and Summers (1989) find little scope for explaining these differentials by unobserved individual characteristics, and argue for some form of rent sharing.

An interesting finding is that large firms pay considerably less than small firms for non-labour inputs — materials and interest rates — though the reasons for these "pervasive and deep" discounts remain unclear. Recent work showing that small firms are often *more* effective innovators than their larger competitors (Acs and Andretsch, 1990) is only briefly mentioned.

The last chapter in BHM argues that small business is not underrepresented politically in the U.S., and the conclusion reiterates their claim to have presented a "fuller picture" of the debate, a claim which is weakened by the gaps in their logic and evidence listed here. BHM's sensible concluding admonition "Do not judge employers by their size alone" (p. 91) takes us back to the larger problems mentioned initially but — ironically — systematically neglected by BHM themselves.

As Howard (1990) emphasises, the boundaries and definitions of firms as well as the nature of their interrelationships vary substantially across countries, and BHM's exclusive concern with the U.S. has probably helped them to miss some of the most significant developments. For example, in north central Italy many manufacturers are linked by flexible cooperative agreements which enable "tiny" firms to "compete globally in state-of-the-art technology niches" (Howard, p. 96). These flexible networks were sponsored by regional government in collaboration with employers' associations and unions, yielding flows of information and know-how quite different from those generated between independent businesses through arms'-length market transactions. Indeed, Best (1990) traces the decline of much traditional manufacturing in the U.K. and U.S. to a variety of factors including their recent government's exclusive reliance on market and price competition. "But if interfirm cooperation is a condition of small-firm success, then policy making based upon the competitive market ideal may actually contribute to industrial decline" (Best, 1990, p. 227).

The share of small firms in Japanese manufacturing is much higher than elsewhere, but many of these firms are often regarded as informal subsidiaries of their large "parent". However, as Best, Howard, Sengenberger and others emphasise, the relationship is better viewed as flexible, long term cooperation, with "parent" corporations sharing "detailed information about production costs and techniques" (Howard, p. 94). Small suppliers not only "get reliable long term markets", but are even lent "state-of-the-art equipment", while the "mix of cooperation and competition is a constant spur to innovation" (p. 96).

Again, small firms seem to pay lower wages and offer less security, while the best graduates queue for jobs — or rather life-time careers — with the most prestigious large corporations. Wage-differentials again might well be rents to ability or elite education.

In (former) West Germany, the size-wage gap is much smaller due to centralized bargaining, and the *Mittelstand* of small enterprises benefit from national training programmes that provide most school leavers with vocational or further education. On the other hand, the highly regulated labour market also provides problems for small business and new startups (Brunowsky, 1988) while much government policy explicitly favours large firms both in Germany and most other European countries (Adams and Brock, 1988).

Agency problems suggest that small, owner-managed businesses are likely to be more efficient than large corporations, and evidence is accumulating in support of this view, as well as for monopoly-rent sharing. Top managerial compensation is much more strongly related to size than to rate of return, creating strong incentives for "wasteful growth and diversification" (Baker, Jensen, and Murphy, 1988). Large manufacturers in Japan and Germany depend on flexible networks of small suppliers, while small business performance is related in many areas to non-market, cooperative relationships that are not easily accommodated in a conventional "markets or hierarchies" type of analysis.

While early claims for small-firm employment effects were undoubtedly exaggerated, it has also been shown that small firms are more frequently subject to credit rationing (as well as paying higher interest rates). There is a case for government support to improve the infrastructure for small business cooperation, credit supply and other aspects of "flexible networking" that could plausibly increase the survival rates and employment impact of small firms. The useful broad surveys by Best (1990) Loveman and Sengenberger (1991), and Howard (1990) emphasize the differing roles of small business across countries as well as the interaction of divergent industrial policies and traditions with private sectors. BHM's attempt to provide "a fuller picture" is too narrowly focussed (in addition to the defects discussed above) to achieve its goal, or to contribute substantially to improving policy and industrial organization in countries like the U.K. and the U.S. where such improvement is most needed.

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