Small Firms and Entrepreneurship: An East West Perspective: A Review Article

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1. Introduction

Interest in small firms and entrepreneurship has extended over the last decade from the US and Britain to the rest of Europe, first Western and then Eastern, as well as to the former Soviet Union. In Eastern Europe and the CIS, much hope is pinned on the emerging entrepreneurial — small-firm — sector to carry these economies out of their currently still-worsening crises. It is therefore particularly appropriate that the new volume edited by Zoltan Acs and David Audretsch (1993) should provide the first overview of small firm development to include both Eastern and Western experience.

As the useful summary Table 12.1 from Acs and Audretsch's concluding Chapter 12, shows there is a remarkable diversity in small firm shares and development even among Western Countries. The book's explicit emphasis is descriptive — "getting the facts straight" — with only two, country specific, regression models, but little attempt to explain intercountry variation in the similar Western economic systems, and no discussion of welfare implications. Clearly such analyses will depend on adequate data, and the material collected here will undoubtedly form a valuable starting point. However, it is also probably true that a point of decreasing returns to further purely descriptive work in this area has been attained, and that researchers should now devote more attention to conventional hypothesis — testing in spite of obvious data — limitations, and to the increasingly urgent policy — decisions in both East and West which have hitherto been largely left in the domain of relatively unqualified political debate.

Abstracting from much of the detailed inter-country variation summarized in the Table, a striking stylized fact emerges, particularly if Japan were to be included as well. The oldest and formerly dominant industrial economies of Britain and the US still have the smallest (Western) small-firm shares, in spite of a relatively high growth rate of this share in the UK. The faster growing and more competitive Japanese, West German and also Italian economies have much larger small-firm shares, and Italy's has been growing rapidly as well. It would be intriguing to relate these facts to the differing systems of industrial organization and corporate governance in these countries along the following lines.

The dominant role of the stockmarket and close relationship between top managerial pay and firm-size in the Anglo-American systems have encouraged what Baker, Jensen and Murphy (1989) called "wasteful growth and diversification", at the cost of profitability and long-term tangible investment. Lack of mutual commitments with other stakeholders such as workers and customers has at the same time provided entrepreneurs with incentives to make quick capital gains from product innovation, rather than fostering development, process innovation and more competitive production (Florida and Kenney, 1990). Lack of infrastructure of the kind provided by most European competitors, from public transport to training, has blocked growth.

In spite of policies to stimulate entrepreneurial start ups, less regulated labour markets, and better developed venture capital, the high rate of both hostile and friendly acquisition of successful small enterprise by empire-building corporate managers in the UK and US have kept small-firm shares relatively low in these countries. In Japan, Germany

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TABLE 12.1
Summary from country studies of small-firm share of manufacturing employment and shift over time[a]

Country	*Year*	*Small-firm employment share (%)*	*Year*	*Small-firm employment share (%)*	*Change*
United Kingdom	1986	39.9	1979	30.1	+9.8
Federal Republic of Germany	1987	57.9	1970	54.8	+3.1
United States	1987	35.2	1976	33.4	+1.9
Netherlands[a]	1986	39.9	1978	36.1	+3.8
Portugal	1986	71.8	1982	68.3	+3.5
Italy[c]					
North	1987	55.2	1981	44.3	+10.9
South	1987	68.4	1981	61.4	+7.0
Czechoslovakia	1988	1.4	1954	13.0	−11.6
East Germany	1986	1.1	–	–	–
Poland[b]	1985	10.00	1937	33.0	−23.0

Notes: [a] A "small firm" is defined as an enterprise with fewer than 500 employees, unless designated otherwise.
[b] A "small firm" is defined as an enterprise with fewer than 100 employees.
[c] A "small firm" is measured as an enterprise with fewer than 200 employees.

and Italy, employee stakeholders are implicitly (as in Japan) or explicitly (as in German codetermination) recognized to be of greater (or equal) importance than outside stockholders, and hostile takeovers are rare. This fosters more cooperative labour relations (except in *large* Italian firms), which in turn allow small firms to build up long-lasting cooperative networks with each other (Italy) or with major corporate "parents" (Japan). These relationships are neither arm's length market transactions, nor hierarchical, so that Williamson's dichotomy arguably misses one the main sources of Japanese and (continental) European growth and competitive advantage (FitzRoy and Acs, 1992).

Neglect of vocational training in Britain and America has further eroded the viability of their manufacturing sectors, and reduced many of their small firms to excessive reliance on low-paid, unskilled labour reminiscent of an earlier, "sweatshop" era. Centralized bargaining and codetermination in West Germany, by contrast, have limited size-wage differentials, and forced the growing sector of small manufacturers to concentrate on high value-added, high quality products which compete in world markets, as do many of Italy's "flexible networks" of small firms. Relationships of this kind, including the symbiotic parent-subcontractor relationship in Japan, actually blur the demarcation and definition of firm-boundaries and sizes, so that size-related statistics merit cautious interpretation in international comparisons.

2. Western country studies

Some of the themes touched upon here are mentioned by Johnson and Loveman (Chapter 10) in connection with Eastern Europe, but first we consider some of the other country-specific evidence presented. Alan Hughes' Chapter 2 provides a detailed overview of a part of recent British experience. Hughes notes that a dramatic decline in manufacturing employment by large firms has principally boosted the small-firm share. In the meantime deepening recession has accelerated the bankruptcy rate of small firms, and highlighted the vulnerability of this sector when banks are generally unwilling to assume an entrepreneurial role in debt renegotiation as an alternative to bankruptcy. Since most new enterprises soon fail in the best of times, these developments underline critique of policy to encourage start-ups when assistance to successful but still small and underfunded survivors might be more productive. Hughes omits any discussion of wages, working conditions, or the crucial role of vocational training.

Michael Fritsch records a somewhat similar development in West Germany in Chapter 3, with a substantial decline in large-firm employment in manufacturing raising the small firm share. However, he fails to note that the decline in total manufacturing employment was much smaller than in the UK, and unfortunately offers no hints on the origins of Germany's much larger traditional small-firm share in craft traditions, codetermination and other institutions including vocational training. A better, brief account of these matters is in Johnson and Loveman's Chapter 10.

In Chapter 4 the editors marshal considerable evidence for a somewhat different pattern in the US. The trend to small-firm employment in manufacturing, and particularly in metal-working, does seem to be influenced by "the establishment of new firms which are apparently replacing old ones" (p. 76). The decline in large manufacturing employment is also important, but not so predominantly as in Europe. Acs and Audretsch also present qualitative evidence on the role of new flexible technologies in reducing economies of scale and hence favouring smaller firms. The shift in demand away from traditional mass-produced goods is a complementary development that has often been mentioned since Piore and Sabel's (1984) pioneering work, and is briefly discussed in the following contribution by Thurik.

The issue of scale economies is also tackled systematically by Roy Thurik in the volume's most analytical Chapter 5 on Dutch manufacturing. Thurik goes beyond descriptive statistics to estimate a cost function with industry-level data and finds "a decreasing importance of fixed costs over time" (p. 102), which suggests declining scale-economies. However Thurik also finds slower productivity growth in small firms, and is unable to reconcile these apparently divergent findings, perhaps due to data problems.

In his Chapter 6 on Portugal, José Mata also presents empirical estimates, not of cost functions, but of small-firm shares in 73 industries, which clearly identify scale economies as a barrier to small-firm entry, and also finds if anything less flexibility in SMEs. Portugal's large SME share is thus attributed primarily to relative underdevelopment. This is again a most useful quantitative exercise, which could presumably have been replicated for other countries to provide more analytical-comparative insight then the descriptive statistics alone.

The important case of Italy is discussed next by B. Invernizzi and Ricardo Revelli (Chapter 7). They find increasing shares of employment by SMEs, a declining productivity gap, and interestingly a *growing* wage gap between SMEs and large firms. They also note much higher labour turnover and shorter tenure in SMEs, as well as "turbulence" or rapid entry and exit. Unfortunately, these interesting characteristics of the SME labour market are not reported for other countries, which is a serious omission, not generally justified by data limitations. The authors do not discuss in any detail the benefits of flexible networks of SMEs in some areas, which others have stressed, but view the SME sector as at least partially segmented into low-pay, low-quality labour. Regressions like those for Holland and Portugal would have usefully complemented this chapter.

3. Eastern Europe

Turning to Eastern Europe, Gerald McDermott and Michael Mejstrik document the decimation of the small-firm sector and the destruction of a competitive industrial base over the last 50 years in Czechoslovakia (Chapter 8). They argue, like many Western advisers, for an industrial policy promoting SMEs to restore the balance and lead recovery. While plausible in principle, this argument neglects adjustment costs and the fact that most workers in Eastern Europe are still employed in large, formerly state-owned and now essentially "non-owned" enterprises-in-limbo. To avoid anarchy, the policy priority may well have to be preservation of even poor jobs by existing uncompetitive large units, with only a *slow* transition to more smaller enterprises, as successful entrepreneurial entrants grow and take up the slack in a process which does seem to be underway in parts of China.

A similarly dismal story for (former) East Germany is recounted by Hans-Gerd Bannasch in Chapter 9. Since that was written, economic conditions have continued to deteriorate in most sectors throughout 1992 and nearly 3 million out of 3.6 million industrial jobs have been lost since reunification. The privatization *Treuhand* trust has failed to find buyers for most manufacturing plants, and also failed to implement even the minimal investment required for survival and continuing employment in unsold enterprise that was part of the agency's political remit. After two years of reliance on idealogical "free marketeers" in the *Treuhand*, and against the background of deepening recession in Western Germany as well as growing political unrest, the government has instigated a major policy-shift in December 1992 (*Der Spiegel*, 1992). This involves abandonment of an obviously unattainable privatization time-table, and avoidance of unacceptable further increase in unemployment by maintaining former state enterprises with substantial subsidies over a transitionary period under appropriate Western management and regulation. This goes some of the way to meeting demands for a more "hands-on" policy approach by Western trade unions.

Nevertheless, Eastern workers are striking for higher wages, after Western unions actually underpinned the massive Eastern wage hikes following reunification which rendered most of the former state sector uncompetitive. The best section on Eastern Europe is Simon Johnson and Gary Loveman's insightful case-study of small business in Gdansk (Chapter 10). Despite successful entrepreneurship the economic situation in Poland has deteriorated in certain respects, with essentially no clear-cut control or ownership structures in place for most enterprises, exploding debt used to pay to current wages and other outlays, a collapsing banking system, and political power struggles between managers and works councils instead of productive cooperation (Wijnbergen, 1992). As Johnson and Loveman point out, successful small firms "cream" the best skilled labour from declining state enterprise, and can pay for performance, yet will only be able to employ a small fraction of the underutilized labour force of large firms in the near future. Underlining the problems of too-rapid transition and neglect of adjustment costs, (former) Russian Prime Minister Yegor Gaidar, a leading advocate of rapid reform or "shock therapy", has been removed by the conservative backlash in the congress in December 1992, a fate that threatens other Eastern reformers, if not their Western advisors, and perhaps even the reform process itself (Goldman, 1992).

In the final Chapter 11, Hans-Peter Brunner seeks lessons for Eastern Europe from developing countries. His theoretical account of productivity growth is unclear and does not reflect current research and controversies in this area (Scott, 1989). Nor is it obvious that the experience of LDCs in transforming predominantly agrarian economies, with frequently disastrous distributional and ecological consequences, can inform Eastern policy on conversion of their large and heavy-industrial conglomerates, into more competitive and less environmentally destructive organisations, without exploding unemployment and political turmoil.

Development of a viable small-firm sector and encouragement of new entrepreneurial ventures is clearly an important part of any sensible long run policy for Eastern Europe, which can offer major welfare gains in particular in services and retailing. However, small firms cannot suddenly employ a displaced national industrial work-force, and a carefully regulated, gradual transition rather than "shock therapy" would seem to be essential (Acs and FitzRoy, forthcoming).

As the editors note in their conclusion, various tentative explanations for differing small firm growth and shares now need more systematic empirical exploration, while welfare implications have yet to be developed. As usual in edited volumes, the contributions reviewed here are uneven in scope and quality. A unified empirical approach across Western countries, including simple regressions of cost functions and share-estimates as presented for Holland and Portugal, would have allowed more systematic comparison than purely descriptive statistics in multi-variate situations. Overall, however, this is a very stimulating collection that will surely become the starting point for much further study of the many questions and hypotheses put forward.

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