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THE ECONOMIC SIGNIFICANCE OF SMALL FIRMS

by DAVID WAITE*

A STEADY growth in the concentration of industry has been a feature of most advanced countries for about half a century. Economic theory attempts to explain this process in terms of technical, managerial, marketing and financial factors affecting existing firms and industries: little is said about the emergence and growth of new firms, and official statistics tell us very little about the smaller unquoted firms in the economy. It was partly to rectify this lack of information and partly because of concern expressed about pressures operating in a discriminating fashion against small firms, that a committee was established in July 1969 to examine this sector. Under the chairmanship of John Bolton, it produced its report[1] in November 1971. Its terms of reference were:

> To consider the role of small firms in the national economy, the facilities available to them and the problems confronting them; and to make recommendations. . . . In the course of the study it will be necessary to examine in particular the profitability of small firms and the availability of finance. Regard should also be paid to the special functions of small firms, for example, as innovators and specialist suppliers.[2]

This paper is principally concerned with Part I of the Report, which is an assessment of the functions and performance of the small firm sector.

DEFINITIONS

In choosing its definition of smallness the Committee had regard not only to the form in which official statistics were presented, but also to the norms in each of their broad industry categories by which relative size could be gauged. The definitions used are reproduced in the Appendix, but in general the characteristics considered apposite to the small firm were:

1. smallness of market share (large number of similar sized firms) and hence lack of individual market power, corresponding to the theoretical concept of pure competition;

* The author is employed in the Economic Intelligence Department of the Bank of England but the views expressed herein are his own and not necessarily those of the Bank.

[1] *Report of the Committee of Inquiry on Small Firms* November 1971, Cmnd. 4811 [The Bolton Report].

[2] Bolton Report, p. xv.

2. close association of ownership and management functions, so that concern was primarily with private unquoted companies and unincorporated businesses;
3. autonomy in decision-making—this excludes subsidiaries of large organizations and individual plants belonging to the same business.

Although any definition is bound to be arbitrary, it is sensible to avoid trying to embrace all sectors in one. Manufacturing is very different from retailing, for example; a 200 employee firm in the first is quite small, while in the second it is large. Similarly, capital and turnover measures cannot be usefully applied across the board because of differing norms in each sector.

THE ROLE OF SMALL FIRMS

Economic theory has tended to sidestep issues of diversity of firm size within industries and changes in structure. Marshall's classic treatment,[3] for example, intended particularly to handle industries with falling costs, is a case in point. In dealing with the 'representative firm', the size of the individual firm is related to its age, and the behaviour of the 'forest' is dealt with by examining the average sized 'tree' in a static setting. A change in the size of the representative firm is a dynamic question affecting the relative growth rates of the constituent members of the 'forest'. There is an implicit assumption in this metaphor of a continuous growth of firms, new large firms being supplied from the ranks of smaller ones to replace those which stagnate and cease to grow. At the other end of the scale, a stream of new small firms enter to replace those leaving the small firm sector by growth or liquidation.

The emergence from the 'costs controversy' of the 'twenties of theories of imperfect competition provided models that could explain the co-existence of firms with different costs levels in terms of 'goodwill' and consumer preference. The small firm, then, could be viewed as enjoying part of the market demand curve and potentially expanding towards the optimum size in the industry.

Steindl[4] criticized the plausibility of the Marshallian view of growth within industries because of the very large range of size between the smallest and largest firms and problems of financing growth, especially the limitations on external borrowing. Against this, however, it should be mentioned that, over a timespan of several decades, substantial growth, particularly of 'high fliers', is feasible,

[3] A. Marshall, *Principles of Economics* Macmillan 8th ed., reprinted 1966.
[4] J. Steindl, *Small and Big Business* Blackwell, 1945.

and it should be remembered that only a few of the smaller firms ever grow out of the sector.

The Bolton Committee took the view that it was essential to maintain an environment that was not hostile to the formation and growth of new enterprises. It considered the prime function of a healthy small firm sector to be the provision of a 'seedbed' for new enterprise and entrepreneurial talent, a source of new lifeblood and ideas, and potential growth to maintain a spur of competition. This is, of course, a long-term view, the principal objective of the Committee.

In the manufacturing and construction sector, 23 per cent of small firms existing in 1963 went into liquidation, ceased trading, or were taken over by 1970 (excluding mortalities of firms founded between these years). The main cause of mortality was takeover, though it is not known what proportion of this activity involved acquisition by very large firms. Even so, the Committee welcomed the fact that at least some mergers were between small firms wanting to improve their market position.

In a static context, as distinct from the long-run, dynamic setting, an industry with many small firms is more likely to be competitive than a concentrated one. The Bolton Committee implicitly accepted a preference for many rather than few firms in an industry in the interest of economic efficiency, potential and actual competition, and checks on monopoly profits. This view needs considerable qualification, however, for the ability of a small firm sector to provide effective competition depends on what barriers to competition there are and the extent to which a few giant firms dominate the industry. The Committee was apparently unaware of two important considerations relating to industrial structure and performance. First, dominant firms may 'tolerate' a fringe of much smaller firms to give the lie to charges of monopoly; independence of the competitive fringe may be largely illusory if they have to follow the price leader. Secondly, concentration of itself does not necessarily breed stagnation, for in oligopoly (small number of sellers) conditions, potential competition across industry boundaries is important for checking monopoly power and maintaining efficiency; rivalry between oligopolists (as an alternative to collusion) within an industry can also serve this end.

Stepping from the implicit assumption hitherto of single product firms into a world of multi-product businesses, it becomes apparent that the greater the number of firms in an industry, the more likelihood there is of variety in output. It is arguable that smaller firms, especially those which specialize in small or luxury market segments,

provide for a need that would not otherwise be met, and hence improve consumer choice. The Bolton Committee sets great store by this function in its case for the small firm. However, though it may often be that specialist items are uneconomic for the large firm to produce, it does not mean that big business never caters for such sectors: there is nothing to stop a large firm setting up a small unit to sell in these markets.

In some industries, particularly the motor and aircraft trades, small firms are important suppliers of components and sub-assemblies to large manufacturers. The latter often consider it uneconomic to produce them and there may be no need for vertical integration because the small firms are already totally dependent on them. In such a situation the independence of the small firm is, virtually, nominal.

In some industries scale economies are not so important and the optimum size of firm is quite small. From a competitive point of view the significance of this is the absence of substantial barriers to entry and the lack of advantages conferred by large size. In service industries, small firms predominate, both in terms of numbers of enterprises and numbers employed; they account for 99 per cent of all firms in that sector and 82 per cent of the employment.

In itself, the fact that the optimum size of firm is small in some industries, large in others, is not the most important consideration for the future of the small firm 'seedbed'. What is significant, for preventing stagnation, is the existence of conditions in which new businesses can be started from which the firms of the future can grow. The history of the giant firms of today has been one of growth through a combination of internal resources, external borrowing and mergers. Firms that grow to compete with the present leaders of industry need not begin life within that industry. Diversification across industry boundaries ensures a flow of ideas that helps to reduce barriers to competition.

In regard to technical progress small firms appear to make a disproportionately large contribution to invention in relation to their expenditure on research and development. This conclusion is supported by evidence of case studies, patents data, employment of qualified scientists and engineers, and shares of recorded R & D expenditure. The Bolton Committee recognized the qualifications needed in interpreting the data, but took the view that flexibility of organization coupled with personal involvement and drive contributed to a greater degree of inventiveness within small firms.

Innovation—the application of known concepts or processes in new, improved ways—is often closely allied to the idea of invention.

Innovation is difficult to quantify partly because of the problem of definition and partly the lack of empirical data which is a consequence. In this situation the Committee could only take a view that rejected two extremes, namely that only the largest firms could afford to innovate and that in large corporations the incentive was lacking. The Bolton Committee view was that small firms can and do contribute to innovation in those fields where they have the appropriate resources.[5]

The Committee laid considerable stress on the vigorous spirit of independence to be found among small businessmen. This has implications for employment opportunities especially for those people who feel lost in a large organization or who do not have formal higher educational qualifications or the desire to go through the educational mill. The less formal nature of the working environment in small firms—which appears to facilitate interpersonal communications and staff relations—is as important to the employee as to the owner (or self-employed person).

In the local community too the small businessman, with his roots there, is a valuable contributor to local government, on the bench and in local charitable and social organizations. The large firm executive, by comparison, is more mobile and less closely attached to a particular local community: a man who lives the best part of his life in one area is likely to be better acquainted with local conditions and sentiment.

WHY SMALL FIRMS SURVIVE

In considering the size distribution of firms in an industry an explanation must be found of how small firms can exist alongside the large. Realizing that an explanation of firm size solely in terms of market size and optimum scale was an over-simplification, the Committee opted for an approach suggested by Lydall.[6] Small firms are examined according to the type of market they serve, falling into three categories:

1. In an industry where production economies of scale exist, the small firm may not be able to compete directly with the large firm on costs, but it can cater for those segments of the market which are uneconomic for larger firms, e.g. luxury goods and specialist items. In a sense, however, the two are not comparable since they are supplying different markets—even if these are purely delineated by tastes. It may be that the small firm is losing out in such areas

[5] See, for example, J. Jewkes, D. Sawyers, and R. Stillerman, *The Sources of Invention* 2nd ed., Macmillan, 1969.

[6] H. F. Lydall, 'Aspects of Competition in Manufacturing Industry', *Bulletin of the Oxford University Institute of Statistics*, Vol. 20 (1958).

because of lessening dispersion of income distribution and the impact of the mass media on tastes.

2. Another role for the small firm is that of supplier to large firms of components or other individual items. Often such small firms are totally dependent on the customer and these jobbing firms[7] may be described as 'satellites'. This sort of dependence is common in the motor and aircraft industries where the large firm often finds it more economic to subcontract to smaller suppliers work that demands speed and flexibility. It is also found in retailing, where suppliers are dependent on multiple stores (such as Marks & Spencer or Woolworth). Here again, the purely nominal independence of the small firm satellite makes it differ little from a department of a fully integrated concern: it cannot be said to be fully autonomous in its decision-making.

3. A category called 'marketeers' competes directly with larger firms in the same or similar markets. Their survival may be accounted for by different production techniques (e.g. different capital/labour ratio) or the lack of scale economies in the industry. There is also the concept of imperfect competition, whereby the smaller firm has its own 'special market' protected by 'goodwill', and imperfect competition in the labour market may secure labour at lower cost, e.g. non-unionized, part-time or women workers. In oligopoly conditions, small firms may be 'tolerated' by their larger competitors. Finally, the sheer tenacity and drive of owner-managers may ensure their survival.[8]

Two surveys for the Committee suggested that the majority of small firms fall into the third category. In manufacturing industries between one-half and three-quarters of small firms seem to be in direct competition with large ones. Marketeering is more common among the larger firms of the 'small' sector, while satellites are mainly the smallest firms. Outside manufacturing the proportion of small firms competing with large ones is generally even higher, particularly in the distributive trades. The Committee did not examine in any greater detail the factors contributing to the survival of marketeers in particular. Among those not considered we may include the benefits of geographical location in relation to materials, markets, competitors and complementary firms—external economies.

PERFORMANCE

One line for comparison of small and large firms is their relative efficiency in the use of resources as measured by net output per

[7] A jobbing firm produces goods to customer specification.
[8] Steindl, Ch. VI.

person and return on capital. Both these measures are fraught with difficulties because the firms are not necessarily engaged in the same activities, selling in the same markets or using the same production processes. Apart from these conceptual problems, there are difficulties of obtaining unambiguous figures for such factor inputs as entrepreneurship and capital, more particularly from unincorporated businesses (which are not distinguished in government statistics from households).

Although net output per person is lower for small firms than for large, this does not necessarily mean a correspondingly lower level of efficiency since the production techniques and capital/labour ratios differ: there is a tendency for small firms to be more labour intensive. In the small firm there tends to be a greater proportion of less skilled operatives, the incidence of overtime and shift-working is lower, and there is a larger proportion of part-time working. When allowance is made for the generally lower level of wage rates (as distinct from average earnings), even for the same type of labour, and lower capital intensity, the level of output per unit of labour comes out at nearly 18 per cent below that in large firms.

Such information as is available from the Census of Production shows that capital intensity among small firms rises with the size of firm, and that small firms, as a group, employ less capital than large firms, but information on the rate of depreciation and the value of capital stock, etc., is not available. It is therefore not possible to relate the lower capital intensity to the lower net output per unit of labour in small firms.

The Committee turned to such information as it could gather to compare the relationship between capital employed and the return on capital (as measured by profits) in the financial accounts of businesses. The use of this measure suffers from the same defect of partiality as the labour measure in so far as it neglects differences in other factors of production (labour and management). Problems also arise in the valuation of capital, especially in the owner-managed firm where there may be an overlap between the owner's personal and business assets. Despite all the qualifications to the data, small firms seem to show a higher return on capital than larger companies, although the difference is not very great. Bolton concluded that, although the partial contribution of labour and capital to profits or net output could not be measured accurately, and there was therefore no way of comparing the relative efficiency with which firms used their resources, there appeared to be no evidence to suggest that small firms were generally any less efficient than the large.

The available evidence, then, suggests that small firms do not waste resources; evidence of a higher return on capital among small firms may simply reflect lower capital intensity; from a long-term viewpoint, the provision of opportunities for entrepreneurial talent may have no counterpart elsewhere.

PAST TRENDS IN THE SMALL FIRM SECTOR

The picture is one of continuing decline. In manufacturing, the share of small firms in employment and output has fallen almost continuously since the mid-1920s. There was also a dramatic fall in the number of small manufacturing firms up to 1948 since when the decline, though at a slower rate, has continued. In the period 1958–63 there was a net fall of 1000 enterprises per annum.

Statistical material is too inadequate in other sectors to make an accurate assessment of trends in the relative contribution of small firms to economic activity. Since 1945 there has been a substantial decline in the number of small retailers, though up to 1966 their share of retail turnover and employment fell relatively slowly. Small firms apparently increased their importance in the motor distributive trades up to the early 1960s but the number of establishments contracted sharply between 1962 and 1967, and this process has probably continued since then. Road transport is an exception in that its size of firm distribution has changed very little since the 1930s.

When comparing concentration patterns with other industrialized countries, despite the obvious pitfall of incompatible data, it appears that the process of decline is common to all, but that it has gone further in Britain than anywhere else. To examine birth and death rates of new firms it is only possible to compare the position with that in the United States where comparable figures are produced. It emerges that the birth rate of new firms is lower in Britain and the average age of surviving firms is greater: little can be said about death rates. The Committee felt that the decline in birth rate was the more important factor contributing to the decline in British small firm activity. Hence it laid great stress in its recommendations on the removal of barriers discriminating against the formation and growth of new businesses.

PROBLEMS FACING SMALL FIRMS

Part of the Bolton Committee's brief was to investigate problems peculiar to the sector, i.e. arising from the smallness of the companies. Many grievances were aired ranging from difficulties of raising

capital to the burden of form-filling, and from the impact of various forms of taxation to the effect of development and planning controls. Attention here will be confined to what appear to be the two most important areas where small firms are discriminated against, namely finance and taxation.

The question of long-term finance for small and medium-sized companies was first highlighted by the Macmillan Committee on Finance and Industry as long ago as 1931[9] when the phenomenon which came to be known as the 'Macmillan Gap' was identified. This was the lack of provision for small and medium sized firms of long-term capital in amounts too small for public issue—this lower limit was reckoned at around £200,000. When the Radcliffe Committee[10] came to look at this question nearly thirty years later they concluded that this gap had been closed, and the Bolton Committee concurred; nevertheless, the latter study did identify an 'information gap' affecting small firms.

In the 'thirties, after the appearance of the Macmillan report, a number of investment companies, specializing in the finance of small business, sprang up, notably Charterhouse Industrial Development and Leadenhall Securities; also, after the war, the Industrial and Commercial Finance Corporation (I.C.F.C.) was set up by the London and Scottish Clearing Banks with support from the Bank of England. I.C.F.C. was given resources to make long-term loans, often with equity participation in the borrowing firms, of sums between £5000 and £200,000. The I.C.F.C. immediately became and remains one of the most important sources of long-term capital for small firms.

Despite the variety of institutions catering for the private company's finance, problems still arise. The small firm depends to a great extent on internal finance and bank borrowing, mainly from the Clearing Banks although the latter is essentially short term. They do so to a much greater degree than large firms. In fact the bank manager, along with the accountant and solicitor, is the most important source of advice on many matters, as well as being the first source of external finance.

The Committee received many complaints from small firms of difficulties in obtaining finance and there seem to be three main contributory factors. First, the branch manager's upper discretionary limit for unsecured loans is often quite low. When the case has to be referred to another office the potential borrower is often unable to provide adequate documentary evidence of his firm's recent

[9] *Report of the Committee on Finance and Industry*, Cmd. 3897 (1931).
[10] *Report of the Committee on the Working of the Monetary System*, Cmnd. 827 (1959).

performance by which his creditworthiness may be assessed: some degree of resentment at external influence may be involved also. Secondly, before the new form of credit control[11] was introduced in 1971, directives on bank lending which gave priority to exporting and manufacturing activities tended to discriminate against service trades—where small firms predominate—making bank borrowing difficult. The new system should remove this form of discrimination. The third factor that may make borrowing difficult is an information gap which may be the fault of the businessman, the bank manager or both. The bank manager should at least be able to advise on alternative sources of finance if his bank does not have the facilities, especially where long-term investment is required. On the other hand, the reluctance of many businessmen to seek help needs to be recognized as a trait.

The small businessman's plea is for funds at a 'fair'—not subsidized—rate of interest. Nevertheless, his idea of what is a fair charge for money seems to be conditioned by experience of (short-term) overdraft rates; the rates on longer-term capital, raised through finance houses, leasing and factoring companies, seem rather to take him aback. The only remedy for this seems to be a process of education and advice on the economics of long-term financing.

The historically high level of taxation in Britain since the war has tended to operate differentially against small private companies. Taxes on capital (especially estate duty) impose a large burden on a business with a few shareholders: this is particularly true of family concerns. Death duties are often assessed on a purely notional valuation of non-marketable assets; payment of the duty involves a severe strain on the firm's liquidity and may force the selling off or closure of the business. High taxation of profits presents greater difficulty for the private company, which relies mainly on retained earnings to finance expansion, compared with the large company that can go to the market. In addition, small firms seem to be less aware than large ones of the effect of inflation on real profits, being lulled into a false sense of security by apparently high nominal profit figures.

Close companies[12] have long been subject to special provisions aimed at preventing the controlling shareholders from using the business for the avoidance of personal taxation. Corporation tax, introduced in 1965, was aimed at encouraging the ploughback of profits by companies since distributed profits were subject additionally to income tax. To prevent owners of close companies using the lower rate on retained earnings to avoid personal tax, a 'required

[11] See 'Competition and Credit Control', *Bank of England Quarterly Bulletin*, June 1971.
[12] A close company is one controlled by five or fewer persons or by its directors.

standard' was established in the distribution of profits: for trading companies this is 60 per cent of after-tax profits plus 100 per cent of investment income. The onus is on the firm to make its case for higher retentions for expansion or current business needs, otherwise any shortfall on the required standard is subject to an assessment for income tax and surtax where appropriate. Although, as the Bolton Committee found, the Inland Revenue has not been unreasonable in making shortfall assessments, the cost of proving the need to retain more than 40 per cent of profits is said to be excessive.

Small firms suffer from taxation policy because it works against the accumulation of private capital which is the primary source of finance for new, risky enterprise. Starting a firm is, inevitably, a gamble, and institutional finance agencies could not be expected to put their money into a business with no past performance as a guide. Whatever feelings may be about the ownership of capital, the fact remains that, if new firms are to come into existence, adequate resources must be accumulated in private hands. There are fewer 'rich uncles' around these days to risk their money in new enterprises; the ones that remain seem often to prefer to invest through the means of a well-organized capital market.

CONCLUSION

The small firm sector is not static. Although the Bolton Committee could not examine the growth pattern of firms over time because of the lack of information, it did suggest that the decline of small firms as a group was due principally to a slower birth rate in a relatively hostile environment. The Committee recommended, not that small firms should be feather-bedded, but that some of the factors discriminating against them should be removed, and that freedom of entry should be maintained and encouraged. The prime importance of small firms, as a sector, is not just in remaining small (though even as small firms they have an important contribution to make) but in providing a seedbed for enterprise and ideas and as a launching pad for growth. The importance of the Bolton Committee has been to throw some light on small unquoted companies about which very little was known before: most previous studies of 'small' firms[13] have been in terms of the smaller end of the Stock Exchange List, where firms have to be a reasonable size to obtain a quotation.

The government, for its part, has accepted most of Bolton's recommendations in principle. It has set up a Small Firms Division

[13] E.g. A. Singh and G. Whittington, *Growth, Profitability and Valuation*, Cambridge University Press, 1968; T. M. Samuels and A. D. Chesher, *Growth, Survival and the Size of Companies (1960–69)* (Mimeograph).

at the D.T.I. to co-ordinate consideration of the Report and to look after the needs of small firms as a whole, and has designated a Minister with special responsibility for small firms. Already, provisions have been made to ease the tax burden on small companies and their interests are being taken into account in the arrangements for Value Added Tax and revised Corporation Tax.

LONDON

Appendix

STATISTICAL DEFINITIONS OF SMALL FIRMS ADOPTED BY THE BOLTON COMMITTEE

Industry	*Statistical definition of small firms*	*Proportion of small firms in the industry 1963*	*Proportion of industry's employment in small firms 1963*	*Average employment per small firm 1963*
		%	%	
Manufacturing	200 employees or less	94	20	25
Retailing	Turnover £50,000 p.a. or less	96	49	3
Wholesale trades	Turnover £200,000 p.a. or less	77	25	7
Construction	25 employees or less	89	33	6
Mining/quarrying	25 employees or less	77	20	11
Motor trades	Turnover £100,000 p.a. or less	87	32*	3*
Miscellaneous services	Turnover £50,000 p.a. or less	90	82	4
Road transport	5 vehicles or less	85	36*	4*
Catering	All excluding multiples and brewery-managed public houses	96*	75*	3*

* Estimated figure subject to substantial margin of error.

Source: Bolton Committee Report, Table 1.I.