2. SMALL FIRMS AND EFFICIENCY

DAVID B. AUDRETSCH

THE TWO VIEWS ABOUT SMALL FIRMS

Two disparate views about the impact of small firms on economic efficiency have emerged in the economics literature. On the one hand is the traditional view in the field of industrial organization that views small firms as imposing excess costs on the economy as a result of a scale of production that is too small to be efficient. According to this traditional view, the inefficient scale of operations results in lower levels of productivity for small firms and lower wages for their workers. The shift in economic activity that has taken place over the previous two decades away from large corporations and toward new and small firms is interpreted as causing a decrease in the standard of living of Americans. Shifting employment out of high-productivity and high-wage firms and into lower-productivity and lower-wage (small) firms reduces the well-being of the American population. According to this traditional view of small firms, any policies that shift economic activity out of small firms and back into large corporations should be encouraged, since they will increase the American standard of living.

With the publication of The Changing Structure of the U.S. Economy: Lessons from the Steel Industry, Zoltan J. Acs (1984) shattered the prevalent conventional wisdom. While the industrial organization literature portrayed small firms as less efficient clones of the large corporations, Acs introduced a radically different view of the small firm. By arguing that entrepreneurs started new firms not simply to duplicate the incumbent firms but rather to deviate in an innovative manner, Acs challenged
the conventional wisdom in industrial organization by proposing a second view of small firms—as agents of change. Under this alternative view, the dynamic contributions made by small firms far offset any static efficiency losses.

The purpose of this chapter is to ask which of these two competing views about the efficiency of small firms is correct—the traditional view of industrial organization or that proposed by Acs some fifteen years ago. The answer is found by sifting through what has now become a large and compelling literature about the economic role of small firms—viewed through the static lens provided by the traditional industrial organization literature and through the dynamic lens of evolutionary economics.

With the hindsight of some fifteen years, it is clear that the dynamic view of small-firm efficiency introduced by Acs (1984) is more consistent with not just the recent wave of theories about the evolutionary role of small and new firms but also with the compelling empirical evidence that analyzes firms and industries through a dynamic lens.

THE STATIC VIEW OF SMALL FIRMS

In thinking about the economic role of small firms, the obvious starting point is the theory of the firm. The field of economics that focuses the most on links between the organization of firms in industries and the resulting economic performance has been industrial organization. The ascendancy of industrial organization in the postwar period as an important and valued field economics came from the recognition not only by scholars but also by policymakers that industrial organization matters. The widespread fear of the Soviet Union that was pervasive throughout the United States in the late 1950s and early 1960s was not just that the Soviets might bury the Americans because they were the first into space with the launch of Sputnik but that the superior organization of industry facilitated by centralized planning was generating greater rates of growth in the Soviet Union. After all, the nations of Eastern Europe, and the Soviet Union in particular, had a “luxury” inherent in their systems of centralized planning—a concentration of economic assets on a scale beyond anything imaginable in the West, where the commitment to democracy seemingly imposed a concomitant commitment to economic decentralization.

Although there may have been considerable debate about what to do about the perceived Soviet threat some three decades ago, there was little doubt at that time that the manner in which enterprises and entire industries were organized mattered. And even more striking, when one reviews the literature of the day, there seemed to be near unanimity about the way in which industrial organization mattered. It is no doubt an irony of history that a remarkably similar version of the giantism embedded in Soviet doctrine, fueled by the writings of Marx and ultimately implemented by the iron fist of Stalin, was also prevalent throughout the West. This was the era of mass production when economies of scale seemed to be the decisive factor in dictating efficiency. This was the world so colorfully described by John Kenneth Galbraith (1956) in his theory of countervailing power, in which the power of big business was held in check by big labor and by big government.