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## **Is Small Beautiful? Some reflections on small businesses and economic development**

Most states today devote significant resources to SME sector promotion. In truth, however, we know rather little about the consequences of small business operations for socio-economic development or the efficiency of economic policies targeting the sector. The literature on the subject has been focused chiefly on the role of SMEs and on economic policy. Unfortunately, it is overflowing with normative statements. The rare comprehensive studies to have examined the long-term processes operating in the private enterprise sector include works by Eugene Staley and Richard Morse [1965], Denis Anderson [1982], Ian M.D Little, Deepak Mazumdar, and John W. Page [1987], Donald R. Snodgrass and Tyler Biggs [1996], and Tulus Tambunan [2000]. Moreover, individual support projects for SMEs are most often evaluated in isolation and usually viewed through the prism of volumes of committed funds rather than verifiable results [ADB, 2009].

That is why it seems profitable to attempt a closer look at the functioning of small business within the economy. So, we will examine the long-term experiences of two countries: Taiwan and Korea. Both countries have been characterized by dynamic economic growth during the past half-century; yet, while Korea's spectacular economic achievements are linked to its large chaebol corporations, "Taiwan is a paradise for small and medium businesses" [Choo, 2000].

Statistics show that both Korea's and Taiwan's manufacturing<sup>1</sup> have evolved according to the same universal pattern. After an initial period of production concentration, smaller firms regained their market share, beginning in the 1970s. In Korean manufacturing large companies' [over 500 employees] share in employment and production reached a peak in 1975, when it amounted to 54.3% and 69.3% respectively. In Taiwan, however, those shares have never surpassed their 1971 levels of 36.1% and 47.3% [Bąkiewicz, 2010].

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<sup>1</sup> Unfortunately, historical data on SME in both Korea and Taiwan are available for manufacturing only.

Since export played a key role in the processes of economic growth in both countries, let us now take a closer look at their respective export enterprise structures. Both countries' footwear industries were important sources of exports: USD 1.3 billion in Korea and USD 1.8 billion in Taiwan, in 1983 [Levy, 1991]. Their export enterprise structures differed, however – Korea had 50 exporters, while Taiwan had as many as 884. In Korea, footwear production was dominated by chaebols relying on sub-contractors, but in Taiwan production was driven by numerous small, independent producers. The situation was similar in the bicycle production industry: in 1980, 541 producers were registered in Taiwan, while in Korea, which had comparable export figures, bicycles were assembled by no more than 74 companies [Chu, 1997].

Thus, there were definite and significant differences between the two national cases as far as the structure of production was concerned. It was also evident in export enterprise-size structures in individual product groups in the two economies.

#### SME DEVELOPMENT IN KOREA AND TAIWAN

In Korea, beginning with General Park's five-year economic plan in 1962, successive governments consistently supported SMEs that showed export potential. Yet, since the majority of SMEs were turned towards the internal market, they remained outside of the sphere of the administration's interest. In addition, on the supply side, SMEs faced serious limitations as a result of governmental economic policies that limited access to credit, means of production and qualified cadres. On the demand side, however, SMEs benefited from the chaebols' concentration on export: they satisfied not only the domestic market demand, which had been ignored by large firms, but also large firms' demand for cooperative production.

In Taiwan, in the 1960s and the 1970s a heavily subsidized state-owned corporation sector had co-existed with a fragmented private sector. There is much reason to believe that economic programs in Taiwan concentrated on the needs of the state-owned corporations sector in selected branches of the economy [Zhu, 2006]. Moreover, the economic strategies placed limitations on the expansion of private businesses. Taiwan's small firms did not benefit from any sustained government support programs. But, blocked in selected branches, without competition from larger rivals on the internal market, small manufacturers proliferated in numbers. Aside from these top-down limitations on private sector development, Taiwanese state authorities essentially did not interfere in the functioning of the private sector.

The comparison of Taiwan's and Korea's early experiences shows that their development strategies were similar in many respects. Protectionist trade policies,

combined with the active promotion of export, played important roles in the shaping of both countries' economic systems. In both cases, private enterprises drove export expansion. But, while South Korean governments promoted the emergence of large corporations, Taiwanese authorities placed tight controls on the concentration of private capital. In Korea, economic activity was closely regulated, the economy was "steered manually", and small industry was relegated to a predominantly supporting economic role, while large exporters took the lead. Taiwanese administrations, for their part, refrained from excessive control over private firms. Thus, during the expansion of labor-intensive export, small production in both countries was shaped by distinct governmental strategies towards the private sector; SME support programs did not play a significant role.

Since the close of the 1970s in both economies the competition advantage that SMEs had traditionally enjoyed – based on labor costs – has been negated. Economic success has increasingly come to depend on the ability to exploit new technologies and flexible methods of production organization. Beginning in the 1980s in Korea dynamic, flexible enterprises came to replace passive subcontractors and artisans; workshops specializing in labor-intensive export goods gave place to producers implementing more advanced technologies and specializing in the production of higher-quality goods for wealthier clients. In the sphere of sector policy, the economy continued to prioritize chaebols. However, SME development also benefitted from undoubtedly positive stimuli, including the sustained protection of the internal market from the competition of foreign goods, large firms' concentration on export production, and production contracts commissioned by exporters. The emergence of modern small business in Korea doubtless also owed much to the government's intensive efforts to ensure high education levels. Other highly important factors included Korea's dynamic economic growth, the population's rising standard of living, the high education level, as well as the growth of democracy and a concomitant change in popular perceptions of entrepreneurship.

An emphatic change in the Korean administration' approach to small businesses followed the Asian financial crisis of 1997. Kim Dae-Jung's government recognized that the weakness of small-scale industry had been one of the causes of the profound economic breakdown and declared that the 21<sup>st</sup> century would be "the age of SMEs". The development of small business also came to be seen as a safeguard against unemployment, which had risen drastically during the crisis. Government support consisted primarily of funding for technological innovations, tax exemptions and credit guarantees. But, the system of credit guarantees was subject to frequent abuses and guarantor institutions suffered large losses [Jung, 2002]. Critics pointed out that the agencies responsible for support programs neglected the real needs of SMEs and did not submit their initiatives to consultation within the sector. Thus, the effectiveness of the Korean authorities' support

for SMEs may elicit doubts. In addition, government programs essentially aimed to support only existing firms and it was only after the crisis that the government began to implement entrepreneurship development programs as part of its promotion of venture capital.

As far as Taiwan is concerned, already in the closing years of the 1970s, in order to improve its export competitiveness, the administration proceeded to liberalize the private sector's operating procedures and undertook a series of initiatives aimed at the development of private firms in the new technology sectors. One of its most important measures was the founding of the Hsinchu Scientific Industrial Park [HSIP] and the national Industrial Technology Research Institute [ITRI]. Within a short time, Hsinchu brought together 13,000 researchers from two universities, six laboratories, two research institutions and 150 electronics firms. New firms were offered numerous privileges, including a five-year tax exemption [Lall, 2000]. Hsinchu's development was in large measure based on close cooperation with research centers in California [Hsu, 2004]. ITRI's activities gave birth to numerous start-ups that eventually became prominent Taiwanese companies on the new technologies product market [Hobday, 1995].

Taiwan intensified measures to support the private sector, including SMEs, only at the beginning of the 1990s, when modern, globalized enterprises were already in operation. Moreover, the rising political power of entrepreneurs during the 1990s played an important role in influencing the composition of development programs. In other words, the democratization and education of civil society helped place SMEs at the forefront of pro-development measures. As in Korea, these programs did not aim to create jobs, generate profits, or balance regional development, but they did prove efficient in modernizing the existing, spontaneously formed SME sector.

Summing up, a prominent characteristic of enterprise size-structure in Korea was the prolonged and intense concentration of production in the largest enterprises – the chaebols. Large firms proved very efficient in building up the foundations of modern industry and export expansion during the 1960s and 1970s. But, when the increasingly negative consequences of the high concentration of production became especially apparent in the aftermath of Asia's financial crisis, in the second half of the 1990s, the Korean government was forced to undertake decisive action to limit the chaebols' dominance. In opposition to Korea, in Taiwan an important role was played by production and business cooperation among numerous small producers and traders. Large business groups began to emerge in Taiwan only at the end of the 1980s, but nevertheless came to dominate Taiwanese export already by the turn of the century.

Despite clear differences in both the size structures of producers and the strategies towards the private sector, the effects on the economic growth of both

countries were nevertheless very similar. That is why one can doubt as to whether enterprise-size structure has any significance for economic growth.

### THE ECONOMIC CONSEQUENCES OF SME SECTOR ACTIVITY

Numerous analyses of the origins of Korea's economic miracle have concluded that the chief catalysts of that success were state-supported, large concerns – the chaebols. However, SMEs also played an important role in Korea's process of economic development, not least by contributing to the chaebols' export expansion [Bąkiewicz, 2008]. Adhering to government directives, chaebols could concentrate on key production areas, while commissioning a significant proportion of production from smaller collaborators. Because of the resulting savings in capital and in labor costs, chaebols were able to increase their capital accumulation. In the aftermath of the Asian financial crisis of 1997, SME activity increased markedly in areas such as new technologies and knowledge-intensive production, significantly raising the Korean economy's competitiveness.

In Taiwan, the fragmented enterprise-size structure had very distinct consequences for the economy. First, labor-intensive light manufacturing grew rapidly in areas such as textiles, as well as plastic and wood products, after which, beginning in the second half of the 1960s, production growth was strongest in the electrotechnical industry. As a result, Taiwan's export offer primarily included technologically simple, relatively low-quality products. Until the 1990s, Taiwan did not become a presence in the automobile or integrated circuit production industries – branches in which the benefits of size come into play and in which the large Korean concerns were consequently competitive. Taiwanese exporters, on the other hand, specialized in the assembly of electrotechnical and computer equipment – product niches in which effective small-scale production is feasible and flexibility is a necessary condition for success.

In addition, the activity of numerous producers and service providers in the informal sector was a potential hindrance for the development possibilities of formal sector enterprises. Excessive competition had the potential to result in such high numbers of small firms operating on the market that the majority of them could not achieve a minimum efficient scale of production. Furthermore, small firms in Taiwan proved to be particularly efficient in labor-intensive production areas, which do not require tying up large sums of capital. However this system provided only limited possibilities for technological development. That is why, at least until the end of the 1970s, the fast-developing pro-export production sector relied heavily on technologies adapted to local needs, rather than on the introduction of innovative technological solutions. This did not occasion significant problems until the mid-1970s, when competition from inexpensive, labor-intensive

items produced in other developing countries began to intensify. Technological modernization necessitated the development of larger enterprises with higher potential for implementing new technologies. Producers who did not dispose of sufficient technological potential, that is, mainly small firms, were left with few choices but to move production abroad or concentrate on services.

The experiences of many countries, including, but not limited to, Korea and Taiwan, confirm that work productivity in small firms is inferior to that observed in larger enterprises [ADB, 2009]. This translates directly into lower wages in small firms. As well, while there are clear differences between enterprise-size structures prevalent in Taiwan and Korea, the Gini coefficient for both countries over the past fifty-year period oscillated within a range of 0.30–0.40 and was among the lowest in the world. This raises doubts as to whether enterprise-size structure has a significant impact on income distribution disparity. This question undoubtedly requires further study.

**Table 1. Economic consequences of SME sector activity**

Sphere of activity	Transmission mechanism	Functions	Dysfunctions
<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>
Employment	Labor-intensive technologies	Potential to generate income with low levels of financial capital resources and management skills. SME functions as a “sponge”, absorbing the labor force – Absorption of labor force surplus – Employment of unqualified labor force	Low labor and production quality
Income	Remuneration for labor	Income for unqualified workers	Low, unstable income levels and low labor productivity
	Production of inexpensive basic goods	Lowering of the cost of living and of labor costs	Higher costs in comparison with mass production
Higher-level needs [Maslow's hierarchy]	Satisfaction	Self-employment	Macroeconomic losses due to the incomplete utilization of resources
Growth of the economy's investment potential – generation of resources	Internal accumulation	Primary accumulation of capital	
	Surplus generation	High capital productivity	Low labor productivity

<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>
Human capital	Technical and organizational skills	On-the-job training; Accumulation of experience; Acquiring of basic qualifications	Lack of formal training; Higher qualifications are acquired within the formal education system or in large firms
Competitiveness of the economy	Enterprise flexibility	Filling market niches; Adapting to market needs; Versatile production offer	Functional instability
	Sector flexibility		High sector growth
	Utilization of the factors of production	Labor-intensive technologies corresponding to the availability of the factors of production	Low production quality
	Technological advancement	Techniques adapted to the relationship of labor and capital costs	Simple technologies; Significantly higher level of technology in larger firms
Balance of payments	Export + import	Labor-intensive export Low import intensity of production	Limited possibilities for the internationalization of activities
State budget	Revenues	“Something is better than nothing”	Ubiquitous evasion of taxation and social contribution responsibilities
	Expenditures	Minor burden on the state budget in comparison with corporate sector subsidies	Low effectiveness of promotional programs

Source: [Bąkiewicz, 2010].

Table 1 presents a proposed classification of the functions and dysfunctions of small business in the socio-economic system. In all spheres of activity, consequences favorable to development are accompanied by specific negative corollaries. For example, SMEs create jobs and generate income [column 3], but have lower productivity, lower working conditions, and lower surpluses [column 4]. On the one hand, SMEs raise the economy's competitiveness because of their flexibility in adapting to market needs [column 3] but, on the other hand, their products are of generally low quality [column 4]. SMEs do not represent a significant burden on the state budget [column 3], but neither do they significantly contribute to it [column 4]. Summing up, the effects of SME activity on both the economy and its development potential are ambiguous. We have to admit: it seems that SMEs'

social functions – job creation and income generation for an unqualified labor force – play a leading role, particularly in poor countries. But it seems that we cannot consider a high number of firms operating in the SME sector to be an indicator of economic policy effectiveness. Indeed, it may well be proof of a country's inability to solve development problems.

Importantly, as the sector modernizes, its positive consequences for the economy increase, while its negative effects weaken: technological levels rise, as do production quality and labor efficiency; there are also marked improvements in the sector's working conditions, in the internationalization of economic activity and in its contributions to the state budget. Furthermore, the functions and dysfunctions of small-scale manufacturing may be viewed as by-products of the macroeconomic environment and, in particular, of economic policy. In other words, SME development potential takes shape under the influence of its environment and is conditioned by the level of economic development. In short, we may say that by modernizing, small-scale manufacturing "repays" its environment for having created the conditions favorable to its development.

The classification of SME functions and dysfunctions, presented above, also indicates that the combination of small-scale manufacturing with larger enterprises creates a system in which the two become mutually complementary. In summary, SMEs create jobs and utilize dispersed financial capital [primary accumulation of capital], while large companies raise labor force qualification levels and generate surpluses. As Staley and Morse [1965] had stated, firms of varying size have characteristics that are specific to them and fulfill distinct functions within the economy.

### FINAL REMARKS

The above study suggests a number of reflections on the adequacy of certain economic development programs and, more broadly speaking, on economic development processes overall.

1. Notwithstanding the distinct differences in size structures in Taiwan and Korea, the observable effects on economic growth in the two countries were comparable. What is more, the consequences of small business activity are not unilaterally positive in either case. This indicates that it is possible to achieve high economic growth with various enterprise-size structures. In other words, beyond the size of economic entities, there exist more important factors affecting economic growth.

2. In both national cases, specific enterprise-size structures formed under the influence of numerous, mutually complementary factors, among which institutional factors exerted an especially strong influence. Consequently, it is doubtful that their specific development experiences can be replicated.

3. In both cases, macroeconomic policies were far more significant than were special programs for the formation of enterprise-size structures. In both countries,



SME support programs did not aim at job creation or income generation for the poorest segments of society, but were geared toward maximizing exports. Nevertheless, for many years, the income growth rates of both countries were among the highest in the world.

Ultimately, our reflections lead to the conclusion that programs supporting SME development, as they are presently carried out in the majority of the world's countries, are based on tenuous assumptions and are not founded on economic realities.

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### *Summary*

On the basis of two Asian tigers' experiences we drew some reflections on small business development. Our study suggests that the sector's functioning is conditioned by numerous interconnected and varying factors. We may, therefore, suppose that attempts to identify universal principles of SME development are destined to fail. More, the activity of small producers within the economy is characterized not only by functions, but also by dysfunctions. Moreover, the effectiveness of the ubiquitous SME support programs is subject to serious doubts. In sum, the universally implemented SME support programs are not rooted in any sound theoretical foundations.

### **Małe jest piękne?**

#### **Refleksje wokół znaczenia drobnego biznesu w rozwoju gospodarczym**

#### *Streszczenie*

W każdym niemal kraju w projekty rozwojowe na rzecz MSP angażuje się znaczne środki. Tak naprawdę niewiele wiemy, ani jakie są konsekwencje funkcjonowania drobnego biznesu dla rozwoju społeczno-gospodarczego, ani jaka jest skuteczność polityki gospodarczej wobec tego sektora. Literatura przedmiotu – choć liczna – pełna jest powierzchownych, normatywnych stwierdzeń. W referacie przedstawiono wieloletnie doświadczenia rozwojowe dwóch krajów – Tajwanu i Korei Południowej. Oba kraje łączy szczególnie wysoka dynamika gospodarcza w ostatnim półwieczu, z tym że w Korei spektakularne osiągnięcia gospodarcze kojarzone są z wielkimi korporacjami – czelobami, a na Tajwanie z drobnym biznesem. Przeprowadzone studia pokazują, że wysoką dynamikę gospodarczą można osiągnąć przy różnych strukturach wielkości przedsiębiorstw. Ponadto, w obu przypadkach dla kształtowania się struktury wielkości przedsiębiorstw polityka makroekonomiczna była dużo bardziej istotna niż programy sektorowe.