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Flexible or fragile? The growth performance of small and young businesses during the global financial crisis — Evidence from Germany

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ABSTRACT

Do crisis times hamper or foster entrepreneurship? We analyze the relative growth performance of small and young firms within the German Mittelstand during the 2009 crisis. We find that small firms exhibit a relative growth advantage compared to larger firms in both stable and crisis times, and interpret this as a flexibility advantage of small size. By contrast, young firms, which show stronger growth in stable times, are disproportionately negatively affected by the crisis. A similar pattern holds for firms showing characteristics commonly associated with a more entrepreneurial attitude. Thus we conclude that crises are detrimental to entrepreneurship.

1. Executive summary

The global financial crisis has triggered a series of papers analyzing the relative growth performance of small and young firms. Results are mixed; while some studies find that small firms are flexible and show a relative better growth performance than large firms, others identify them as fragile.

Our paper contributes to this literature by asking whether a crisis hampers or fosters entrepreneurship. Crises times are said to hamper entrepreneurship because they impede the smooth process of creative destruction continuously underway in times of stability, for example by creating a level of uncertainty that aggravates the entrepreneur's job of discovering profit opportunities. Moreover, the associated credit crunch deprives entrepreneurial activity of the needed resources. Thus, stabilization policies are conducive to entrepreneurship, as Milton Friedman argued in 1968.

The other view, associated with Joseph Schumpeter for more than hundred years, interprets crisis times as periods where the process of creative destruction turns disruptive as it represents the response of a large number of entrepreneurs to disequilibria emerging from a period of stability. Thus, stabilization policies dampen the entrepreneurial dynamic unleashed in crisis times.

Against this background we make use of a unique dataset covering the German Mittelstand from 2003 to 2012, with 72,594 observations from 29,374 firms, generated through an annual survey of the Kreditanstalt für Wiederaufbau (KfW). Concretely, with the help of a pooled OLS model, we test whether firms with a more entrepreneurial attitude show a better growth

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performance than their less entrepreneurial peers and whether entrepreneurial firms fare worse (the Friedman view) or better (the Schumpeter view) in the global financial crisis.

We identify entrepreneurial firms not only by small size and young age, but by additional characteristics as well. This is motivated by theoretical and empirical contributions suggesting that size and age are imperfect measures of the extent to which a firm has an entrepreneurial attitude. For example, many small businesses are not entrepreneurial as they prefer stability and independence to innovation and growth. Our expanded list of observable firm characteristics providing information about the firm's entrepreneurial ambitions include (1) international market outreach, as more entrepreneurial firms target not only regional, but also national and international markets, (2) sole proprietorship and (3) ownership by people who were previously unemployed, as these firms are more likely to be more risk-averse and their owners “entrepreneurs out of necessity”, and (4) firms run by directors who are also the owners and hence “truly” represent entrepreneurship.

Our findings broadly and robustly support the view that crisis times are detrimental to entrepreneurship. This holds for young firms in particular. Moreover, young firms, firms with a broad market orientation, director-founder firms and firms that do not operate as sole proprietorships show significantly lower growth than their respective peers in the crisis, and significantly higher growth in times of stability. Thus, assuming that we have properly identified firms with a more entrepreneurial attitude, our results suggest that a crisis does not seem to represent a disruptive version of the smooth process of creative destruction observed in times of stability, but rather its reversal.

The Schumpeter view is supported by firm size results only: Smaller-sized firms receive an extra growth boost in crisis times. We interpret this inconsistency as a confirmation of the view that small size is a poor proxy for entrepreneurial behavior. Small size predominantly reflects flexibility, which is an asset in normal times, and especially valuable in crisis times. Consistent with this, we find that flexibility is exploited more efficiently by firms with a more entrepreneurial attitude. Having said this, future research in the field will provide ample scope to expand and modify our analysis and to challenge our results, by identifying better proxies for entrepreneurship and by testing our hypotheses for other countries and crises. The policy conclusions of our study are as follows: First, fighting a financial crisis on the macro level with the goal of maintaining or restoring stability is a promising policy approach to support entrepreneurship. Second, on a more practitioner-oriented level, our results suggest that a seemingly less entrepreneurial approach in normal times might represent reasonable economic behavior, as this option seems to offer a kind of safety premium in crisis times. Indeed, the relative growth record of such firms suggests, following Kirzner, that they account more properly for price differentials prevailing in a crisis than their allegedly more entrepreneurial peers. Thus, if it were not for Schumpeter's characterization of the entrepreneur as risk-taking and creative, the behavior of these firms could be called entrepreneurial as well.

2. Introduction

How does a financial crisis impact the growth performance of small and young businesses? Do they perform relatively better than large firms due to their higher degree of flexibility or do they suffer more given their fragility? And what does this imply for entrepreneurship in crisis times compared to periods of stability? These questions are of direct policy relevance as small and young firms are often regarded as synonymous with, and drivers of, growth and innovation. Thus, the global financial crisis triggered a series of papers analyzing the relative growth performance of small and young firms. Results are mixed; while some studies find that small firms show a relative better growth performance in crisis times (Moscarini and Postel-Vinay, 2012), others show that small businesses are more vulnerable during a crisis (Kolasa et al., 2010; Ferrando et al., 2014). Finally, results by Fort et al. (2013) indicate that size only matters when firms are young; established firms are largely unaffected by the crisis, irrespective of their size.

The conflicting results of empirical studies echo the ambivalence of economic theory on the question at hand. This ambivalence goes back to Schumpeter (1934). He argued that a crisis represents a burst of new entrepreneurial activity in the form of “creative destruction”. Hence, the “Schumpeter view” calls for laissez-faire policies in crisis times, as policy interventions would undermine entrepreneurial activity, i.e. the efforts of innovative small and young businesses leading the economy to a new equilibrium. However, Schumpeter also acknowledged that compared to large and mature firms, small and young businesses might suffer more in a crisis due to their fragility in terms of size, capital and reputation.[2] Moreover, as Friedman (1968) emphasized, economic stability encourages entrepreneurship as it facilitates the discovery of profit opportunities. Thus, the “Friedman view” calls for an active policy response reestablishing stability to foster entrepreneurship and a return to growth.

Our paper contributes to the empirical literature on relative firm growth in periods of crisis by analyzing the flexible versus fragile trade-off from an explicit entrepreneurial perspective. Most previous studies lack this perspective, either because they implicitly equate small size and young age with entrepreneurship or because they are based on a crisis theory which is not driven by entrepreneurship – as claimed by Schumpeter – but exogenous to entrepreneurship. Against this background we review the links between financial crises and entrepreneurship, and present and critically discuss arguments suggesting that small and young firms are good proxies for entrepreneurship. Based on a review of the entrepreneurship literature we develop a list of additional characteristics associated with (more) entrepreneurial firms. In addition to small size and young age, we identify firms with a broader market orientation, including exports, and run by directors who are also the firms' founders or owners as being more

[2] Indeed, careful reading of Schumpeter (1934) reveals that he identifies booms and recessions as the consequences of creative destruction, suggesting that they are unavoidable in a dynamic economy. However, he also stresses that it would be beneficial for entrepreneurship if certain types of crises, namely those with an “abnormal course of events” triggering “meaningless and functionless” losses and destruction, could be avoided.