SURVIVAL OF THE SMALL FIRM

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The overwhelming majority of business units are extremely small; many are one-man businesses and many more employ only a handful of workers. In spite of the predominance of large firms, it is rather surprising to find that small firms still constitute such an important element in modern industry.

Many small firms are the creation of individuals whose interest in promoting expansion may be limited. From every point of view—technological, marketing, financial and entrepreneurial—further growth may be possible and profitable, but human inertia may overcome economic incentive. The proprietor may fear the loss of his freedom if expansion takes place. The business as it stands may afford him a comfortable livelihood and adequate leisure. Growth of the business may entail more work and worry that is compensated for by additional profit. Economists assume that entrepreneurs will seek to maximise their profits and there is no question that this is the most reasonable assumption on which to base their theories. But what we have called ‘inertia’ (which may itself be a form of economic calculation) undoubtedly plays an important part in the real world of business affairs.

Small firms flourish most readily in industries where the optimum size of firm is small. In industries where economies of scale—and especially technical economics—are great, small firms are under a handicap. In most industries, moreover, some small firms are for ever being launched as new enterprises, since it is usual in business, as in human existence, to start small and grow.

There are other considerations which favour the small firm. Where quality, variety, and attention to detail are important, the small firm often has the advantage over its larger competitor. There may be important factors even in industries where the advantages of large-scale working are most apparent. Prof. Allen has pointed out that in the finishing end of the steel industry where the product is highly specialised, the small firm can often work to advantage.\(^1\) In the weaving branch of the cotton industry, variety and quality considerations minimise the advantages of the large firm. Small firms often flourish where labour is unorganised or in small towns where alternative employment is difficult to find. Labour can, therefore, be obtained cheaply and pressure can be successfully exerted on wage rates in difficult times. Also, where an industry is dominated by a few large firms, the continued existence of small firms may be tolerated in that they do

\(^1\) British Industries and Their Organisation, 1935, p. 132.
not threaten the monopolistic position of the large firms. They provide superficial evidence that monopoly does not exist, and afford some guarantee against the emergence of new competition. Finally, harmonious relations between management and labour may be a source of important economies to the small firm. The importance of this factor is recognised by many of their larger rivals who spend large sums on labour management and welfare schemes in an effort to secure the willing co-operation of contented employees.

We have to consider, in this connection, the importance of market imperfections. Small firms are often protected within limits by the goodwill of consumers, transport costs, etc., and the large firm may find it impossible to squeeze them out of existence. Small firms may depend for their existence upon the possession of more or less assured markets. The small unit also frequently displays greater flexibility than the large unit, its overhead costs are lighter and therefore, it is less vulnerable to depression, the entrepreneur's remuneration can be varied within wide limits, variation of product to meet changes of demand is more possible, mistakes in manufacture or the buying of raw material are less serious, and so on.

Market limitations of one kind or another provide the most important explanation of the continued survival of the small firm. In some industries the main productive operations are necessarily dispersed over a very wide area. Geographically scattered small firms may operate more economically than large. Rather than incur high transport costs (including waste in transit) by supplying distant customers, firms may prefer to produce on a small scale for local needs only. Whenever firms are distributing their products over a thinly-populated district, expansion will involve heavy outlays on marketing to set against any savings in the cost of manufacture, and the firms will remain small. This is true also of sources of supply. If the raw materials of an industry are widely scattered, and are expensive to assemble at a central site, production will tend to be carried on in scattered factories drawing on local supplies. The milling of timber, grain and minerals illustrates this tendency while the furniture trade industry illustrates the first.

The obstacle of high transport costs is all the greater when markets and sources of supply are not only diffused but also overlap. If production is carried on by small firms up and down the country, the cost of assembling and radiating supplies is greatly reduced, and since producers and consumers remain in close contact with one another, there is no need for a long chain of middlemen.

Distance, in other words, provides the small firm with a sheltered zone which other firms can with difficulty penetrate. Each small firm, supplying a local market, is practically insulated from competition, but if it tries to pursue its way into more distant markets, it meets with keener and keener competition round the fringe of invasion. This market resistance to expansion checks the growth of firms to their
optimum size. The check will be greater the higher the cost of transport, the more scattered the market and the sources of raw materials, and the more they overlap.

This line of reasoning can be extended from geographical to any other limitation of the market. Each firm is normally marketing a product which differs slightly from the products of its competitors. In the shoe trade, for example, no two firms cater for exactly the same shape of feet, specialise in exactly the same range of sizes, use leather of exactly the same quality, or market their shoes in exactly the same pattern and style, with exactly the same guarantees and advertisements. The market is broken up, not only by distance, but by the tastes, habits, and prejudices of consumers. The market for each firm is limited by the requirements of the customers who are within its ‘sphere of influence’. There is thus a market resistance to expansion which can be overcome only by finding new buyers or by invading the market of other firms. This puts the firm to the expense either of special concessions to its customers, or of an advertising campaign, or of the manufacture of new brands of product. It has to attract new customers by reducing its price, or by selling a better quality of product, or by doing something equally costly. These costs of growth, like high transport costs in a scattered market, halt the expansion of the firm below the optimum. They shelter the small firm by penalising invasion of its market. The more varied the attachments which consumers form (the less the density of demand), and the less responsive they are to efforts to change their attachments (e.g., by advertisement, or by concessions in service, quality, or price), the more difficult will be to dislodge small firms from their hold on the market. It is only when consumers are indifferent from whom they buy, and what brands they buy or when they actually have a preference for dealings with large firms that the market ceases to be a major obstacle to expansion.

The market obstacle can, however, be circumvented in two ways: by setting up branch factories, or by manufacturing a wide range of products or brands of the same product. The setting up of branch factories is a way of circumventing the geographical limitation of the market; the manufacture of a wide range of products is a way of circumventing the psychological limitation. Neither of these ‘dodges’ is altogether satisfactory.

Branch factories under a central management can supply the adjacent territory without incurring the high transport costs and other marketing expenses of a single large establishment. They can specialise in the articles, brands, and sizes required locally, and supply orders promptly from a stock which is small in comparison with the stock carried by independent units. Each branch can participate in the technical improvements made by the others, and can detect and eliminate waste by comparing its accounts regularly with theirs. Risks are spread, since a period of bad trade in one district can be set against a
period of good trade in another, while if production is held up at one plant by fire or strike, customers can still be supplied from other plants. These and similar advantages make for the combination of scattered plants in a single firm when the individual plants are prevented from growing by market limitations.

Distance, however, sets a limit to the combination of plants just as it does to the size of the individual plant. The more scattered the units and the poorer the system of communication between them, the more insuperable are the difficulties of efficient supervision by the central office. If local circumstances differ greatly, responsible and expensive district managers must be appointed. Each plant must be given more latitude, and this makes all the harder for the central office to keep them in step with one another, and frame a suitable policy. In short, branch factories sooner or later bump up against the managerial obstacle to expansion.

The same obstacle checks the multiplication of products, patterns, styles, etc., within a single plant. It is only through the sacrifice of great economies in management (and also in technique) that firms can overcome the market obstacle to expansion by extending their range of product. The work of management becomes more complicated, and at the same time the technique appropriate to the large-scale manufacture of a single product or style of product has to be abandoned. More than this, multiplication of products very often fails in its object. For if every firm adopts the same expedient and tries to supply ‘the whole gamut of varieties’ sold by its competitors, it will end by producing every thing on a small scale and selling in a market which has shrunk because of the universal rise in costs of production. The public will be offered a wide variety of styles, but it will be denied the benefits of large-scale production, for each firm will manufacture much the same varieties as its competitors, instead of specialising on a limited range of styles and turning them out on a scale approaching the optimum. Sometimes the optimum scale of production is very small, and the economy of concentrating on a few special lines is confined to the time saved in re-setting machinery. But more often the failure of firms to specialise more narrowly causes waste from the social point of view, while market resistances to growth simply increase pari passu with the variety of output of the typical firm.

Apart altogether from the social waste involved, the production of a whole range of styles, while it may be forced or appear to be forced on each manufacturer by the action of his competitors, does not free a firm from the limitations of its market. The pressure to expand may be diffused over a wide area; but so, is the resistance to expansion. If one firm markets a new variety of product, other firms tend to follow that. Even if they do not, they can threaten retaliation in other ways. Suppose, for example, that the new variety sells well. Then unless new layers of demand are tapped, sales will be mainly at the expense of the
old varieties, and competing firms will find themselves in difficulties. They must either reconcile themselves to reduced sales or fight to retain their ‘share’ of the market. Very likely, they will fight-for instance, by cutting prices, by spending more on advertising. The firm which took the initiative will then lose some of its original gains. So long as the threat of reconciliation has to be faced, therefore, the marketing of new varieties of product is not greatly successful in overcoming market resistance to growth.

There is a market resistance to expansion on the side of supply as well as on the side of demand. A firm—or more frequently an industry—may find it difficult to obtain adequate supplies of one or more of the factors of production adequate, that is, for optimum production. Labour, land, materials, or money-capital may be scarce, so that larger supplies can be obtained only at increasingly higher rates of pay. A rise in output will then bring about a rise in costs. Rather than incur such additional cost, firms may be content to remain smaller than the optimum.

Financial Obstacles

An important reason for the survival of small firms is the difficulty of procuring sufficient capital. A small firm seeking to expand has generally to finance extensions to plant out of profits, or out of the personal savings of its owners and their friends. It has not a sufficient reputation with the investing public to raise capital through the medium of the Stock Exchange, and does not make large enough profits to permit of rapid expansion. The rise of the joint stock system, however, has done much to remove the financial obstacle to growth—particularly for firms which are already fairly large.

Managerial Obstacles

First of all, the range and complexity of the problems of management are greater in large than in small firms. In any industry, therefore, where there is need of constant supervision and rapid decision, where each firm must use a great deal of management, or ‘decision taking’ per unit of product, small firms will predominate. Their advantages lie in the absence of divided responsibility, in the attention which they can give to detail and in their ability to cater exactly for the wants of their customers.

Regarding the predominance of small firms, the conventional explanation gives great weight to market obstacles and to financial obstacles but, unquestionably, managerial obstacles have been singled out as the most important, if not unique, cause of the survival of the small firm.¹

The proposition that management is the factor limiting the size of the firm appears to be based on the following arguments:

(a) That co-ordination must be the act of a single centre and, therefore, the principle of division of labour cannot be applied to this task.

(b) That the supply of co-ordinating ability available to the firm thus cannot be expanded along with an increase in the supply of other factors.

(c) That the supreme co-ordinating authority must have knowledge of the detail of problems as a condition of their solution. Thus the larger the field in which co-ordination is attempted the greater must be the knowledge possessed by the co-ordinators.

(d) That every increase in size beyond a certain point can be achieved only by lengthening the ‘scalar chain of authority’, thus increasing the costs of co-ordination which at some point must exceed the declining economies in this and other spheres.

(e) That the scalar chain of authority cannot be indefinitely extended.

The first proposition rests on a gross over-simplification of the process of co-ordination in group organisation. All but the smallest organisations possess a multi-centred system of co-ordination in which a supreme co-ordinator is served by and dependent on a varying number of subordinate co-ordinators. Although the supreme co-ordinator bears the ultimate responsibility for all decisions, this does not prevent him from delegating to subordinate authority to make certain co-ordinating decisions. Without such delegation growth beyond the stage of face-to-face management by the owner-manager becomes impossible. With delegation, there is clearly, division of labour in respect of the function of co-ordination. Both Prof. Robinson and Mr N. Kaldor¹, in fact, admit the possibility of delegating a certain measure of authority for the achievement of co-ordination and the existence of advantages to be derived from division of labour in this field. Prof. Robinson’s view is that “in a large modern business there is the greatest possible division of labour not only in production, but also in administration”². If it is admitted that the principle of division of labour can be applied to the task of co-ordination, then the second argument in support of the proposition that management is the factor limiting the size of the firm cannot be regarded as valid, since the problem of co-ordinating the policies and activities of the expanding firm can be met by breaking down the task of co-ordination into sectors of manageable proportions. But the burden of detail becomes enormous particularly in a business made up of scattered plants faced with their own special problems.

If there is little devolution of responsibility to departmental and branch managers, they are deprived of initiative and degenerate into mere cogs in the machine. If, on the other hand, responsibility is delegated subordinates of outstanding ability must be appointed and must be handsomely paid. Even when loyal and responsible subordinates can be hired fairly cheaply, a businessman is still faced with the difficulty of exercising effective control over them. But he is unlikely to be able to manage more than four or five departmental heads without causing endless delays or sacrificing his authority and becoming no more than a rubber stamp.

In dealing with the third argument, it is admitted that effective co-ordination requires knowledge of the detail of the problems involved, but, since he may draw on his subordinates’ knowledge of the detail, it is not essential that the supreme co-ordinator should be acquainted personally with it.

Turning now to the fourth and fifth arguments adduced in support of the proposition that management is the factor limiting the size of the firm, it appears, first, to be held that in order to rebut this proposition it is necessary to demonstrate the possibility of organising an infinitely large unit without loss of efficiency. The concept of an infinitely large unit, however, is demanded only by a special case, namely perfect competition with its unrealistic assumptions of perfectly elastic supply of the factors of production and a perfect market for all levels of output. In all other cases, in order to demonstrate that co-ordination is not the factor limiting the size of the firm, it is sufficient to show that a firm may expand without encountering increasing costs of co-ordination or management up to a point within the limits fixed by the scarcity of economic resources.

Approaching the problem from this angle, the first impression is that the supporters of the view that co-ordination is the limiting factor appear to underestimate the magnitude of the unit that can be organised effectively on the basis of a relatively short scalar chain. Leaving aside for the moment the question of costs, it may be concluded that the expansion of the firm within the limits set by scarcity of resources, far from involving the indefinite extension of the chain of authority, probably requires no more than six or, at the most, seven levels of authority to cover all possible cases.

The argument, however, may be taken a stage further. So far it has been assumed that ultimately expansion can take place only as a result of the lengthening of the scalar chain of authority. This arises from the proposition that there is an upper limit of five or, at the most, six subordinates who can be co-ordinated by one individual.

1 Henry Fayol, General and Industrial Management.
There is, however, a point of some importance which appears to have been overlooked. The proposition applies to the co-ordination of subordinates whose duties interlock. By reducing number of points of contact the task of co-ordination is lightened and the area of the co-ordination activity may be extended without loss of efficiency. Where the supreme co-ordinating authority retains mainly the making of major investment decisions the number of immediate subordinates possible may be very large. Technical considerations may in some instances require an irreducible minimum of interlocking especially at or near the operational level, but in many cases much could be done to reduce interlocking even at this stage.

On the basis of these considerations, it can be argued that the firm may expand not only vertically by lengthening the scalar chain, but also horizontally by extending in an appropriate manner the range of the co-ordinator’s responsibility at each level or by a combination of the two processes. Advantage may be taken of this factor in a number of different ways. Units of operation may be multiplied in parallel under the immediate control of the supreme co-ordinator or may be grouped informations under subordinate co-ordinators according to the requirements indicated by the main features of the industry.

It is convenient at this point to deal with the suggestion that the upward cause of the average cost curve arises from the greater complexity of the producing unit as it grows in size thus encountering increased difficulties of co-ordination and management. This suggestion, which is usually associated with the view that problems of co-ordination begin to emerge at relatively low levels of output, appears to spring from certain assumptions about the nature of control and its distribution in the firm. Prof. Chamberlin, for example, in dealing with the proposition that decentralisation may eliminate the problems of complexity by reproducing in substantially independent units the conditions found at the minimum point in the cost curve, appears to argue that, since the firm cannot divest itself completely of control of its component parts, conditions are not duplicated and therefore, the efficiency of these parts is presumably adversely affected. But decentralisation as embodied in the ‘formation’ in fact, gives opportunities for further specialisation of managerial and co-ordinating functions in both the unit, and the formation commands consequent further economies. If the single unitary form of organisation is postulated the result may well be the emergence of problems of co-ordination at relatively low levels of output but, as Prof. Chamberlin notes, the effect of decentralisation may often be to postpone net diseconomies far beyond the scale of production to be found in reality.

The following conclusions emerge from the above discussion. (1) The problem of co-ordination as such is not intractable as has frequently been suggested, since the principle of division of labour can be effectively applied without requiring the organisational structure
of the very large firm to be complex or to extend over a large number of levels of authority.

(2) By appropriate measures of decentralisation and control the firm may expand without incurring increasing costs of co-ordination over a range sufficiently wide to cover all possible cases within the limits imposed by scarcity of resources.

(3) Hence the proposition ‘that an optimum firm with an upper limit imposed by the difficulties and cost of co-ordination is both logically satisfactory and a necessary hypothesis to explain the existing facts’¹ is open to some doubt.

(4) The reasons for the survival of the small firm are not to be found in the field of co-ordination or management. Market imperfections, non-rational elements in both producers’ and consumers’ choice, ignorance of the best techniques and unwillingness or inability to accept the consequences of a policy of decentralisation probably represent the most important factors in the survival of the small unit.

In spite of the fact that the problems of management and co-ordination are not really limiting factors of the size of the firm tending towards small firms, we must realise that outstanding organising ability is not plentiful, and that the managerial obstacle is strong. This is suggested by the fact that a very large proportion of giant businesses have been built up in their own life time by a few exceptional men. Napoleon’s dictum, ‘How rare men are!’ applies as much to industrial as to military organisation, and points to one further explanation of the survival of small firms.

The firms of each industry, to use Marshall’s famous analogy, are like the trees of the forest, some growing and becoming stronger every year, some losing vitality and giving place to others. There is a process of growth and decline in which firms of many different sizes compete for survival.

Growth of firms may be restricted in other ways. A small firm may clearly see and strive towards a higher optimum. During the development period output may actually decline while costs rise steeply. Such temporary losses will probably be budgeted for, but they may be underestimated and prove to be greater than the firm can bear. An adverse cyclical fluctuation of demand may occur during the development phase which may not have been allowed for when the development plan was drawn up. Many small firms which aspire to be large firms are cut off in their youth. Despite the heavy mortality among small firms, the prestige attached to ‘being in business on one’s own’ ensures that sufficient new small firms are established to fill the ranks. This is particularly so where entry is relatively easy, where there is no high premium on specialised knowledge, and where market imperfections are pronounced as in some branches of retail trade. Risks are heavy, but large numbers of potential consumers are always ready to take a chance.

¹ Robinson, The Structure of Competitive Industry, p. 256.