

Sources of Growth: the Entrepreneurial Versus the Managed Economy

David B. Audretsch* and A. Roy Thurik**

*Georgia State University, Tinbergen Institute at Erasmus University Rotterdam (EUR) and
Centre for Economic Policy Research (CEPR), London

**Centre for Advanced Small Business Economics (CASBEC) and Tinbergen Institute, Erasmus
University, Rotterdam and EIM Small Business Research and Consultancy, Zoetermeer

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Abstract

The purpose of this paper is to suggest that a fundamental shift in Europe, along with the other OECD countries, is taking place. This shift is from the managed economy to the entrepreneurial economy. While politicians and policy makers have made a plea for guidance in the era of entrepreneurship, scholars have been slow to respond. The purpose of this paper is to make a first step identifying and articulating these differences. We do this by contrasting the most fundamental elements of the newly emerging entrepreneurial economy with those of the managed economy. We identify fifteen trade-offs confronting these two polar worlds. The common thread throughout these trade-offs is the increased role of new and small enterprises in the entrepreneurial economy. A particular emphasis is placed on changes in economic policy demanded by the entrepreneurial economy vis-à-vis the managed economy. We then explore whether restructuring towards the entrepreneurial economy has been conducive to economic growth and job creation. Our empirical analysis links the stage of the transition towards an entrepreneurial economy to the growth rates of European countries over a recent period. We find that those countries which have introduced a greater element of entrepreneurship have been rewarded with additional growth.

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Professor David B. Audretsch
Tinbergen Institute
Economics
Erasmus University Rotterdam
P.O. Box 1738
3000 DR Rotterdam, the Netherlands

Professor A. Roy Thurik
Centre for Advanced Small Business
Erasmus University Rotterdam
P.O. Box 1738
3000 DR Rotterdam, the Netherlands

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1. Introduction

Economic growth and employment creation are twin horns of not just the European dilemma but of what looms as the major challenge confronting the West.¹ Over 11 percent of the work force in the European Union was unemployed in 1997, ranging from 6.1 percent in the United Kingdom and 6.2 percent in the Netherlands, to 11.1 percent in Germany and 12.6 percent in France. As the *Financial Times* points out, “These variations have emerged even though the position of people without good education and training has deteriorated everywhere over the past 20 years.”² Individual countries, have responded to the twin horns of the growth-employment dilemma with a broad spectrum of policy approaches. Led by France and Germany, continental European countries have generally pursued policies of maintaining the status quo, while the United Kingdom and the Netherlands have been bolder at reducing the role of the state.

This divergence of policy approaches across countries is new. In the first three post-war decades, the countries of Western Europe and North America pursued economic policies, although not identical, which had a high degree of similarity. As Galbraith (1956) articulated, something of a convergence had taken place throughout the Western economies in the way that the model of “managed capitalism” was developing. It seemed that all countries were converging toward economies dominated by a handful of powerful enterprises, constrained only by the countervailing powers of the state and workers.³ The 1950s and 1960s were an era of high and increasing concentration of economic activity. Perhaps the ascendancy of industrial organisation as a field in economics during this period came from the need to address what became known as *the concentration question*. The scholars of industrial organisation responded by producing a mass of literature focusing on essentially three issues: (i) how much economic concentration actually exists? (ii) what are the economic welfare implications of an oligopolistic market structure? And (iii) given the evidence that economic concentration is associated with efficiency, what are the public policy implications? Oliver Williamson’s classic 1968 article, “Economies as an Antitrust Defence: The Welfare Trade-offs,” became something of a final statement demonstrating what appeared to be an inevitable trade-off between the gains in productive efficiency that could be obtained through increased concentration and gains in terms of competition, and implicitly democracy, that could be achieved through decentralising policies.

The fundamental issue of public policy at that time was how to live with this apparent trade-off between concentration and efficiency on the one hand, and decentralisation and democracy on the other. The public policy question of the day was, *How can society reap the benefits of the large corporation in an oligopolistic setting while avoiding or at least minimising the costs imposed by a concentration of economic power?* The policy response was to constrain the freedom of firms to contract. Such policy restraints typically took the form of public ownership, regulation and competition policy or antitrust. At the time, considerable attention was devoted to what seemed like glaring differences in policy approaches to this apparent trade-off by different countries. France and Sweden resorted to government ownership of private business. Other countries, such as the Netherlands and Germany, tended to emphasise regulation. Still other countries, such as the United States, had a greater emphasis on antitrust. In fact, most countries relied upon elements of all three policy instruments. While the particular instrument may have varied across countries, they were, in fact, manifestations of a singular policy

¹ For example, *The Economist* (11 May, 1996, p. 86) points out, “Ask any European what is today's biggest policy problem, and without hesitation he will say: unemployment. Ask an American economist the same question, and you will hear something about flagging productivity growth.”

² “Strategies for Jobs,” *Financial Times*, 18 July, 1997.

³ This view was certainly represented in the influential book written by Jean-Jacques Servan-Schreiber in 1968, *The American Challenge*.

approach – how to restrict and restrain the power of the large corporation. What may have been perceived as a disparate set of policies at the time appears in retrospect to comprise a remarkably singular policy approach – a managed economy.

In response to the rising unemployment coupled with stagnant growth of the past decade, this singular policy approach has broken down. A new policy approach has emerged which we will term the entrepreneurial economy. To characterise fundamental differences between the old and emerging systems is a formidable task for both policy makers as well as scholars. While traces of this shift can be found in different lines of research across a broad spectrum of fields within and beyond economics, there are also insightful references in the popular press as well as the political debate addressing the most pressing policy issues of our day. In response to their direct accountability to the public, policy makers have been quicker to acknowledge the emergence of changing economic forces.⁴ While politicians and policy makers have made a plea for guidance in the era of entrepreneurship, scholars have been slower to respond. The purpose of this paper is to make a first step in identifying and articulating these differences. We do this by contrasting the most fundamental elements of the newly emerging entrepreneurial economy with those of the managed economy.

Quantitative and qualitative changes in the job market were the first hint of a shifting economic system. One manifestation has been a divergence in job creation and reduction of unemployment across countries, between the forerunners that have shifted towards the entrepreneurial economy, like the Netherlands, Denmark and the United Kingdom, and the laggards still obsessed with perfecting the managed economy, like Germany, or rethinking the managed economy, like France. Why have the policies central to the entrepreneurial economy, such as deregulation, privatisation and labour market flexibility not diffused rapidly to other countries still burdened with unemployment and stagnant growth? As the OECD points out in the 1997 *Employment Outlook*, “the failure of continental European countries to adopt its recommendations reflects their fear of increased earnings inequality. The question is whether it is possible to deregulate without suffering these malign effects.”⁵ The problem seems to be that the benefits from structural change are accompanied only at a perceived cost in terms of important economic goals, such as income equality, the social safety net, a high level of public goods available to all, and a high level of mean wages. To reap the gains from structural change in terms of greater competitiveness, economic growth, and ultimately increased employment demands a loss, or at least a perceived loss of certain other economic policy goals.

The consequences of economic restructuring away from the managed economy to the entrepreneurial economy are enormous and encompass virtually every dimension of economic life. No field of economics alone is capable of capturing shifting economic systems. Our task in this paper is to decompose this shift into tractable elements. We do this by identifying fifteen trade-offs involved in restructuring economic activity towards the entrepreneurial economy versus maintenance of the status quo managed economy. We discuss these fifteen trade-offs confronting these two polar worlds. The common thread throughout these trade-offs is the increased role of new and small enterprises in the entrepreneurial economy. A particular emphasis is placed on the changes in economic policy demanded in the entrepreneurial economy vis-à-vis the managed economy. We then explore whether restructuring towards a more entrepreneurial economy has been conducive to economic growth and job creation. Based on an analysis linking the stage of the transition towards an entrepreneurial economy to the growth

⁴ As *U.S. News and World Report* (16 August, 1993) observes, “What do Bill Clinton, George Bush and Bob Dole have in common? All have uttered one of the most enduring homilies in American political discourse: That small businesses create most of the nation’s jobs.”

⁵ Quoted from the *Financial Times*, 18 July 1997.

rates of European countries over a recent period, we find that those countries which have introduced a greater element of entrepreneurship have been rewarded with additional growth.

2. The Trade-offs

The Overview

The managed economy, as characterised by Chandler (1977 and 1990), thrived for nearly three-quarters of a century. Why has an alternative system, which we term as the entrepreneurial economy emerged? The answer has to do with globalisation. The emergence of the entrepreneurial economy is a response to two fundamental aspects of globalisation – the advent of low-cost but highly skilled competition in Central and Eastern Europe as well as Asia, and the telecommunications and microprocessor revolution which has greatly reduced the cost of shifting standardised economic activity out of high-cost locations, such as Europe and into lower-cost locations elsewhere in the world. The comparative advantage of high-wage countries is no longer compatible with routinised economic activity, which can be easily transferred to lower-cost regions outside Western Europe. Maintenance of high wages requires knowledge-based economic activity which cannot be costlessly diffused across geographic space. The first trade-off we examine is between localisation and globalisation. Knowledge based economic activity results in innovations that are more radical and less incremental. The second trade-off is between radical and incremental innovations. An inherent characteristic of knowledge is high uncertainty, which individuals assess differently. Differences in the evaluation of knowledge result in an increased role of new and small firms. Small firms were viewed negatively in the managed economy because their sub-optimal size imposed a less efficient use of resources. The third trade-off compares the view that increased employment requires a reduction in wages with the view in the entrepreneurial economy that higher wages can accompany increased employment.

Stability, continuity and homogeneity were the cornerstones of the managed economy. By contrast, turbulence, diversity and heterogeneity are central to the entrepreneurial economy. These are examined in trade-offs four, five and six. The relationship between workers and firms also varies between the managed and entrepreneurial economies. Trade-off seven examines control versus motivation. The boundary between the firm and the industry is the subject of trade-off eight – market exchange versus firm transaction. The interface between firms is the focus of trade-off nine, where competition and co-operation are viewed as substitutes or complements. The tenth and eleventh trade-offs focus on the role of scale economies and continuity on the one hand, and flexibility and change on the other.

The final four trade-offs involve government policy. They cover the goal of policy (stimulation versus regulation), the target of policy (inputs versus outputs), the locus of policy (local versus national), and the finance of firms.

2.1. Localisation versus Globalisation

The meaning of geographic space differs between the entrepreneurial and managed economy. In the managed economy, the standardisation of products and production reduces the importance of regional-specific characteristics and idiosyncrasies. This is because of the difference in the most important factors of production between the managed and entrepreneurial economies. As represented by the neo-classical production function, production in the managed economy results from the inputs of land, labour and capital (Romer, 1992). While these traditional inputs still play a role, in the entrepreneurial economy, knowledge has emerged as the most important factor of production. A recent literature from the new growth theory argues that knowledge differs inherently from the traditional factors of production in that it cannot be

costlessly transferred across geographic space (Krugman, 1991a and 1991b; and Lucas, 1993). This is why under the entrepreneurial economy, geography plays a more important role in that knowledge tends to be developed in the contexts of localised production networks embedded in innovative clusters.

In rediscovering the importance of economic geography, Paul Krugman (1991a, p. 5) asks, "What is the most striking feature of the geography of economic activity? The short answer is surely concentration...production is remarkably concentrated in space." Perhaps in response to Krugman's concern, a literature in economics has recently emerged which focuses on the implications of the spatial concentration of economic activity for economic growth. Theoretical models posited by Romer (1990), Lucas (1993), and Krugman (1991a and 1991b) link increasing returns to scale yielded by externalities within a geographically bounded region to higher rates of growth. The empirical evidence clearly suggests that R&D and other sources of knowledge not only generate externalities, but studies also suggest that such knowledge spillovers tend to be geographically bounded within the region where the new economic knowledge was created (Audretsch and Feldman, 1996; Audretsch and Stephan, 1996; Jaffe, Trajtenberg and Henderson, 1993, and Jaffe, 1989). That is, new economic knowledge may spill over, but the geographic extent of such knowledge spillovers is limited.⁶

The importance of location and geographic proximity in a world increasingly dominated by E-mail, fax machines, and electronic communications superhighways may seem surprising and even paradoxical at first glance. After all, the new telecommunications technologies have triggered a virtual spatial revolution in terms of the geography of production. According to *The Economist*, "The death of distance as a determinant of the cost of communications will probably be the single most important economic force shaping society in the first half of the next century."⁷

The resolution of this paradox lies in the distinction between knowledge and information. While the marginal cost of transmitting *information* may be invariant to distance, presumably the marginal cost of transmitting *knowledge*, and especially *tacit knowledge*, rises with distance. Von Hippel (1994) demonstrates that high context, uncertain knowledge, or what he terms as *sticky knowledge*, is best transmitted via face-to-face interaction and through frequent contact. Proximity matters in transmitting knowledge because as Kenneth Arrow (1962) pointed out some three decades ago, tacit knowledge is inherently non-rival in nature, and knowledge developed for any particular application can easily spill over and be applied for different purposes. Similarly, Zvi Griliches (1992, p. 29) has defined knowledge spillovers as "working on similar things and hence benefiting much from each other's research." Thus, Glaeser, Kallal, Scheinkman and Shleifer (1992) have observed that "intellectual breakthroughs must cross

⁶ An important finding of Jaffe (1989) and Audretsch and Feldman (1996) is that investment in R&D by private corporations and universities spills over for economic exploitation by third-party firms. In these studies the knowledge production function was modified where the innovative activity within a geographical unit of observation -- a state -- was related to the private corporate expenditures on R&D within that state as well as the research expenditures undertaken at universities. Not only was innovative activity found to increase in the presence of high private corporate expenditures on R&D, but also as a result of research expenditures undertaken by universities within the geographic area. In order to explicitly identify the recipients of R&D spillovers, Acs, Audretsch and Feldman (1994) estimated separate knowledge production functions for large and small firms. Their results suggested that the innovative output of all firms rises along with an increase in the amount of R&D inputs, in both private corporations and university laboratories. However, R&D expenditures made by private companies play a particularly important role in providing inputs to the innovative activity of large firms; and expenditures on research made by universities serve as an especially key input for generating innovative activity in small enterprises.

⁷ "The Death of Distance," *The Economist*, 30 September, 1995.

hallways and streets more easily than oceans and continents." Stephan (1996) explains the role that working together in close proximity plays in generating new breakthroughs in science.

That knowledge spillovers tend to be geographically localised is consistent with frequent observations made by the press, business community, as well as by policy makers. For example, *Fortune* magazine points out that, "business is a social activity, and you have to be where important work is taking place."⁸ A survey of nearly one thousand executives located in America's sixty largest metropolitan areas ranked Raleigh/Durham as the best city for knowledge workers and for innovative activity.⁹ *Fortune* magazine reports, "A lot of brainy types who made their way to Raleigh/Durham were drawn by three top research universities...U.S. businesses, especially those whose success depends on staying atop new technologies and processes, increasingly want to be where hot new ideas are percolating. A presence in brain-power centre like Raleigh/Durham pays off in new products and new ways of doing business...Dozens of small biotechnology and software operations are starting up each year and growing like *kudzu* in the fertile business climate."¹⁰

Under the managed economy, the traditional factors of land, labour and capital are predominant as sources of comparative advantage. This was clearly the case in mass production where abundance of capital determined the comparative advantage (Chandler, 1977). Local characteristics and regional idiosyncrasies are irrelevant as a knowledge source and therefore as a source of competitive advantage. In the managed economy, geography provides a platform to combine mobile capital with (immobile) lower-cost labour (Kindleberger and Audretsch, 1983). In the entrepreneurial economy the comparative advantage is based on innovative activity. An important source of this innovative activity is knowledge spillovers which cannot be easily diffused across geographic space. Local characteristics and regional idiosyncrasies provide a rich source of new knowledge in the entrepreneurial economy. The *death of distance* resulting from globalisation has shifted the comparative advantage of high-cost locations towards economic activity that cannot be costlessly diffused across geographic space. The creation and spill over of tacit knowledge is a localised phenomenon. Thus, in the entrepreneurial economy local proximity and regions have emerged as an important locus of economic activity.

2.2. Radical Innovation versus Incremental Innovation

Innovations can be considered to be incremental when that they are compatible with the core competence and technological trajectory of the firm (Teece, Rumult, Dosi and Winter, 1994).¹¹ The implementation of such incremental innovations do not require significant change in the firm or its personnel. By contrast, a radical innovation can be defined as extending beyond

⁸ "The Best Cities for Knowledge Workers," *Fortune*, 15 November, 1993, pp. 44-57.

⁹ The survey was carried out in 1993 by the management consulting firm of Moran, Stahl & Boyer of New York City.

¹⁰ *Fortune* magazine reports, "What makes the triangle park work so well is a unique nexus of the business community, area universities, and state and local governments...It is home to more than 34,000 scientists and researchers and over 50 corporate, academic and government tenants specialising in microelectronics, telecommunications, chemicals, biotechnology, pharmaceuticals, and environmental health sciences," ("The Best Cities for Knowledge Workers," *Fortune*, 15 November, 1993, p. 46). *Business Week* ("Seattle, A Multimedia Kind of Town: Microsoft's Backyard is Home to a Host of CD-ROM Upstarts," 25 July, 1994, p. 44) similarly reports a cluster of innovative activity located in the Seattle region, "These start-ups clustered in and around Seattle are determined to strike it big in multimedia, a new category of software combining video, sound, and graphics. Why Seattle? First and foremost, there's Microsoft Corp. The \$4.5 billion software giant has brought an abundance of programming whiz kids to the area, along with scores of software start-ups. But these young companies also draw on Seattle's right-brain side: its renowned music scene, acclaimed theatre, and a surprising array of creative talent including filmmakers, animators, writers, producers, and artists."

¹¹ Archibugi and Pianti (1992) show that what holds for firms also holds for countries.

the boundaries of the core competence and technological trajectory of the firm. Implementation of a radical innovation would require significant changes in the firm and its personnel. The managed economy was designed to absorb change within a given technological paradigm, and hence, the typical firm excelled at incremental innovation. By contrast, in the entrepreneurial economy, the capacity to break out of the technological lock-in imposed by existing paradigms is enhanced.

The industry life-cycle theory introduced by Raymond Vernon (1966) is typically considered to link trade and foreign direct investment to the stage of the life-cycle. There do not appear to be direct implications for the relevance of radical versus incremental innovations. But a more thoughtful examination of the framework of the industry life-cycle suggests that the relative importance of radical versus incremental innovations is shaped by the industry life cycle.

There have been various versions of what actually constitutes the industry life cycle. For example, Oliver Williamson (1975, pp. 215-216) has depicted the industry life cycle as, "Three stages in an industry's development are commonly recognised: an early exploratory stage, an intermediate development stage, and a mature stage. The first or early formative stage involves the supply of a new product of relatively primitive design, manufactured on comparatively unspecialised machinery, and marketed through a variety of exploratory techniques. Volume is typically low. A high degree of uncertainty characterises business experience at this stage. The second stage is the intermediate development state in which manufacturing techniques are more refined and market definition is sharpened, output grows rapidly in response to newly recognised applications and unsatisfied market demands. A high but somewhat lesser degree of uncertainty characterises market outcomes at this stage. The third stage is that of a mature industry. Management, manufacturing, and marketing techniques all reach a relatively advanced degree of refinement. Markets may continue to grow, but do so at a more regular and predictable rate...established connections, with customers and suppliers (including capital market access) all operate to buffer changes and thereby to limit large shifts in market shares. Significant innovations tend to be fewer and are mainly of an improvement variety."

While not explicitly stated by Vernon (1966) or Williamson (1975), the role of R&D does not stay constant over the industry life cycle. In the early stages of the life cycle, R&D tends to be highly productive, so that there increasing returns to R&D. In addition, the costs of radical innovation tend to be relatively low while the cost of incremental innovation and imitation tend to be relatively low. Because innovation in newly emerging industries tends to be more radical and less incremental, it is more costly to diffuse across geographic space for economic application in lower-cost locations.

By contrast, as an industry evolves over the life-cycle, the cost of radical innovation tends to increase relative to the cost of incremental innovation and imitation. Strong diminishing returns to radical innovative activity set in. This is not the case for incremental innovation and especially imitation. An implication is that it requires an increasing amount of R&D effort to generate a given amount of innovative activity as an industry matures over the life cycle. At the same time, it requires a decreasing amount of R&D expenditures to transfer new technology to lower cost locations, because innovation activity tends to become less radical and more incremental (Dosi, 1982 and 1988; and Nelson, 1990 and 1995).

This means that information generated by R&D in mature industries can be transferred to lower-cost locations for economic commercialisation. By contrast, the knowledge resulting from R&D in newly emerging industries cannot be easily transferred to lower-cost locations for economic commercialisation. Thus, under the managed economy incremental innovative activity along with diffusion played a more important role. This type of innovative activity, while often requiring large investments of R&D, generated incremental changes in products along the

existing technological trajectories. In the entrepreneurial economy, the comparative advantage of the high-cost location demands innovative activity earlier in the life-cycle. Early stage innovative activity consists of radical innovation, which is more involved in creating and developing new technological trajectories rather than following existing technological trajectories.

2.3. Jobs and High Wages versus Jobs or High Wages

One of the most striking policy dilemmas in the managed economy was that unemployment could be reduced only at the cost of lower wages. In the entrepreneurial economy the choice is less ambiguous. High employment can be combined with high wages, just as low wages do not necessarily imply high employment.

The policy dilemma between employment creation and wage levels was the response to the wave of corporate downsizing, which has left virtually no OECD country untouched. The United States Labour Department recently reported that as a result of corporate downsizing "more than 43 million jobs have been erased in the United States since 1979."¹² This includes 24.8 million blue collar jobs and 18.7 million white collar jobs. Between 1980 and 1993, the 500 largest U.S. manufacturing corporations cut 4.7 million jobs, or one quarter of their work force (Audretsch, 1995). Recent downsizing announcements by U.S. corporations include 123,000 job cuts by AT&T, 122,000 by IBM, and 99,400 by Boeing. Since 1986 IBM has reduced employment by about 45 percent.¹³ The rate of corporate downsizing has apparently increased over time. During most of the 1980s, about one in 25 workers lost a job. In the 1990s this has risen to one in 20 workers.¹⁴

Such downsizing has not been unique to the United States but has become increasingly rampant throughout Europe. Consider the case of Sweden. Some 70 percent of Sweden's manufacturing employees work for large companies, most of them multinationals, such as Volvo, which have been constantly shifting production out of the high-cost location, Sweden, and into lower cost countries, through outward foreign direct investment. Between 1970 and 1993 Sweden lost 500,000 private sector jobs, and unemployment is currently 13 percent of the work force. And Sweden is not an exceptional case. For example, every third car that is manufactured by a German company is actually produced outside of Germany.¹⁵ Similar corporate downsizing has taken place in Germany.¹⁶ For example, the German chemical industry is once again profitable and exhibiting strong growth. At the same time, the largest firms in the industry continue to downsize and reduce employment. In 1994 employment fell by 4.7 percent to 531,000. And it is predicted that an additional 30,000 jobs will be lost to downsizing.¹⁷ Corporate downsizing has not been isolated in the chemical industry.¹⁸ By the end of 1994 Siemens had 12,600 fewer employees than in 1992.¹⁹

¹² "The Downsizing of America," *New York Times*, 3 March, 1996, p. 1.

¹³ "Big Blue's White-Elephant Sale," *Business Week*, 20 February, 1995, p. 26.

¹⁴ "Out One Door and In Another," *Business Week*, 22 January, 1996, p. 41.

¹⁵ Globalisierung: Auslandsproduktion deutscher Autohersteller," *Handlesblatt*, 31 January, 1994.

¹⁶ "Wir Wollen Geld Sehen," *Der Spiegel*, 20 February 1995, pp. 100-102.

¹⁷ "Chemie: Höhere Gewinne, weniger Arbeitsplätze," *Die Welt*, 21 January, 1995, p. 12.

¹⁸ As *Newsweek* ("Lost on the Infobahn: Europe is Losing the Technology Business to U.S. and Japanese Firms," 31 October, 1995, pp. 40-45) observes, "For the men who run the Siemens Corp., the very heart of Germany's electronics industry, these are the years of blood and anguish."

¹⁹ Similar waves of downsizing have been reported in Japan ("Gentle Downsizing in Japan," *International Herald Tribune*, 24 February, 1996, p. 11).

If corporate downsizing has been rampant throughout OECD countries, why is there such a large variance in unemployment rates?²⁰ For example, unemployment in the United States, United Kingdom and the Netherlands has actually been falling. How can these seemingly incompatible phenomena be reconciled?²¹ Because the more entrepreneurial economies have been more successful at creating new jobs to compensate for jobs lost to corporate downsizing. It is small firms in general, and new firm start-ups in particular that have been the locomotive of employment creation.²² For example, Audretsch (1995) found that 1.3 million new jobs in manufacturing were in fact created by small firms between 1976 and 1986, while the number of large manufacturing jobs actually decreased by 100,000. Subsequently, between 1987 and 1992, small companies (with fewer than 500) employees created all of the 5.8 million new jobs in the United States. Over that same period, large companies recorded a net loss of 2.3 million jobs. Between 1980 and 1993 the 500 largest U.S. manufacturing corporations, or the *Fortune 500*, cut 4.7 million people, or one quarter of their work force.

Konings (1995) found that for the United Kingdom there is a negative relationship between gross job creation and plant size but a positive one between gross job destruction and plant size. Robson and Gallagher (1994) show that about one-third of all new employment in the United Kingdom between 1971 and 1981 was in firms with fewer than twenty employees. In the 1980s nearly one-half of all jobs were created in such firms (although they accounted for about one-fifth of total employment in 1985). And between 1987 and 1991 large firms in the United Kingdom, like their counterparts in the United States, were net job shedders. All of the new employment was contributed by small firms. Hughes (1993) provides evidence suggesting that this was in part due to downsizing of the largest firms in the economy, and in part due to an actual expansion of economic activity contributed by small firms. Virtually identical results have been found by Baldwin and Picot (1995) for Canada.

As a study by Wagner (1995) shows, Germany is apparently one of the only developed industrialised countries where net job creation is not systematically and negatively related to firm size. Wagner finds that while gross job creation and destruction rates tend to decline with firm size, net job creation rates and firm size are not systematically related.²³ With the exception of Germany, these two stylised facts appear to be remarkably robust – small firms have created most of the new jobs in Europe and North America but tend to provide lower levels of wage and non-wage compensation.

One concern about the job creation contributed by small firms is that they are associated with lower wages. There is a large body of consistent empirical evidence linking the size of a firm to wages. This is important because an important vehicle for entrepreneurship is the new and small firm. Probably the most cited study is that of Brown, Hamilton and Medoff (1990, pp. 88-89), who conclude that, “Workers in large firms earn higher wages, and this fact cannot be explained completely by differences in labour quality, industry, working conditions, or union status. Workers in large firms also enjoy better benefits and greater job security than their counterparts in small firms. When these factors are added together, it appears that workers in large firms do have a superior employment package.” For example, Audretsch, van Leeuwen,

²⁰ It should be pointed out that in the last few years some large multinational corporations have been increasing employment. In its cover story, “Big is Back,” *The Economist* (24 June, 1995) documents the resurgence of large multinational corporations.

²¹ Since 1986 IBM has reduced employment by 183,000 from a base of 406,000, or by 45.81 percent (“Big Blues White-Elephant Sale,” *Business Week*, 20 February, 1995, p. 26.

²² The literature on employment generation and firm size can be found in Davis, Haltiwanger and Schuh (1996a and 1996b) and Carree and Klomp (1996).

²³ Wagner's (1995) result only emerges when the firms are classified according to their average number of employees in the base and end year.

Menkveld and Thurik (1995) show that small firms²⁴ provide a level of employee compensation in manufacturing that is only 83 percent as high as that in large firms in the United States manufacturing, 84 percent in the Netherlands, and 73 percent in Japan.

This apparent trade-off between wages and employment is the result of static, cross-section studies taken at a single point in time. A different picture emerges when a dynamic analysis is introduced. This dynamic analysis suggests that people start firms to pursue new but uncertain ideas. The only way they can discover if these new ideas are viable is through the trial-and-error experience provided by the market (Jovanovic, 1982). They subsequently learn, or discover, through experience, whether or not the idea is viable. If it is viable, the firm will survive and grow. If it is not viable the firm stagnates and ultimately exits. An important line of research, spanning a broad spectrum of time periods and countries supports this dynamic view of industries (Geroski, 1995). Start-up activity is high in almost every OECD country. Audretsch (1995) has shown that it is greater in industries where there is a higher degree of uncertainty than in industries where there is less uncertainty. In addition, there is systematic evidence that negative relationships exist between firm age and growth, and firm size and growth, as well as positive relationships between firm size and the likelihood of survival, and firm age and the likelihood of survival (Geroski, 1995). This evidence supports the dynamic view of industries that people start firms to experiment with new ideas. Most of these experiments fail, but some succeed, resulting in lower survival rates but high growth rates of the new entrants.

A different line of research, based on logitudinal data sets, shows that the wages and productivity of new firms increase as the firm ages (Audretsch, van Leeuwen, Menkveld and Thurik, 1995; Baldwin, 1995). Taken together, these two lines of research imply that, as new firms mature, the small low wage firm of today becomes the high wage firm of tomorrow. Similarly, the small low productivity firm of today becomes the high productivity firm of tomorrow (Baily, Bartelsman and Haltiwanger, 1996). New and small firms are in motion. Through growth new firms generate not just greater employment but also higher wages. The growth of new firms ensures that the greater employment does not come at a cost of lower wages, but rather the opposite – higher wages.

The cross-section trade-off between firm size and wages, which reflects the policy dilemma under the managed economy, emerged for two reasons. First, the composition of small firms includes mostly enterprises that are doomed to fail. Their inclusion pulls down the average wage of small firms. Second, the higher growth rates of surviving small firms, results in subsequent higher wages.

But again, how is it possible that the average income in Silicon Valley is 50 percent greater than for the rest of the country and at the same time, employment has increased by 150,000 jobs, or 15 percent, between 1992 and 1996?²⁵ Similarly, the Netherlands have in the last few years succeeded in reducing unemployment without drastic reductions in wages. In the entrepreneurial economy there is no trade-off between high wages and employment growth. It is possible to have both, but only when economic activity is based on new knowledge.

2.4. Turbulence versus Stability

The managed economy of the post-war period was characterised by remarkable stability. This stability is characterised by product homogeneity and durability of demand, resulting in a constant population of firms, and a low turnover rate of both jobs and workers. This stability

²⁴Small firms are defined as those enterprises operating at a level of output less than the minimum efficient scale (MES) level of output.

²⁵ “The Valley of Money’s Delights,” *The Economist*, 29 March 1997, special section, p. 1.

was conducive to mass production. Just as Taylorism provided a managerial mechanism for ensuring the stability and reliability of workers in the production process, competition focused on the dimension of prices but not necessarily product differentiation.²⁶

The entrepreneurial economy is characterised by turbulence.²⁷ The industrial landscape of the United States has been transformed within a remarkably short period of time. A number of corporate giants such as IBM, U.S. Steel, RCA and Wang have lost their aura of invincibility. Only slightly more than a decade ago Peters and Waterman in their influential best-selling management book, *In Search of Excellence: Lessons from America's Best Run Companies*, identified IBM as the best-run corporation in America and perhaps in the entire world. At the same time has come the breathtaking emergence of new firms that hardly existed twenty years ago, such as Microsoft, Apple Computer, Intel, Gateway, Dell and Compaq Computer.

In the 1950s and 1960s it took two decades to replace one-third of the Fortune 500. In the 1970s it took one decade. And in the 1980s one-third of the Fortune 500 firms were replaced within just five years. Perhaps even more impressive than the handful of new enterprises that grow to penetrate the Fortune 500 are the armies of start-ups that come into existence each year - and typically disappear into oblivion within a few years. In the 1990s there are around 1.3 million new companies started each year (Audretsch, 1995). That is, the entrepreneurial economy is characterised by a tremendous degree of turbulence. It is an economy in motion, with a massive number of new firms entering each year, but only a subset surviving for any length of time, and an even smaller subset that can ultimately challenge and displace the incumbent large enterprises.

Why is the entrepreneurial economy characterised by less stability and more turbulence? The answer has to do with the organisation and management of foresight, or the creation of new ideas. As Nelson and Winter (1982) emphasise, the role of diversity and selection has been at the heart of generating change. The process of creating diverse ideas and selecting across these diverse ideas is important in both the managed and entrepreneurial economies. However, what differs is the management and organisation of the process by which diversity is created as well as the theatre of selection. In the managed economy, research activities are organised and scheduled in departments devoted towards novel products and services. The management of change fitted into what Nelson and Winter (1982) call the *routines* of a firm. According to Schumpeter (1942, p. 132), "Innovation itself is being reduced to routine. Technological progress is increasingly becoming the business of teams of trained specialists who turn out what is required and make it work in predictable ways." The ability of the existing corporations to manage the process of change pre-empted any opportunities for entrepreneurs to start new firms. This meant that relatively few firms were started and few firms failed, resulting in a remarkably stable industrial structure. Chandler (1990) examined the largest 200 firms in the United States, Britain and Germany over the first half of this century and found that they maintained a remarkably stable position. Teece (1993, p. 214) interprets these findings: "Chandler's data on rankings of the largest industrial firms (for 1917, 1930, 1948 for Great Britain; 1913, 1928, 1953 for Germany) indicate considerable stability in rankings – at least as compared to what economic

²⁶ See Chandler (1977).

²⁷ According to *Business Week*, (Bonus Issue, 1993, p.12), "In recent years, the giants of industry have suffered a great comeuppance - as much from the little guys as from fierce global competition. IBM continues to reel from the assaults of erstwhile upstarts such as Microsoft, Dell Computer, and Compaq Computer. Big Steel was devastated by such mini-mills as Nucor, Chaparral Steel, and Worthington Industries. One-time mavericks Wal-Mart Stores and The Limited taught Sears, Roebuck a big lesson. Southwest Airlines has profitably flown through turbulence that has caused the big airlines to rack up \$10 billion in losses over the past three years. And a brash pack of start-ups with such names as Amgen Inc. and Centocor Inc. has put the U.S. ahead in biotechnology - not Bristol-Myers, Squibb, Merck, or Johnson & Johnson."

theory would predict. The firms that were leaders (as measured by asset size) in their industrial groupings often remained there over long periods.” Similarly, the share of total U.S. manufacturing assets accounted for by the largest 100 corporations increased from about 36 percent in 1924, to 39 percent after the Second World War to over 50 percent by the end of the 1960s, causing Scherer (1970, p. 44) to state that, “Despite the (statistical) uncertainties, one thing is clear. The increasing domestic dominance of the 100 largest manufacturing firms since 1947 is not a statistical illusion.” Similarly, Dennis Mueller (1989) has shown that the profits of the largest corporations tended to persist in the long-run during the post-war period.

In the entrepreneurial economy, foresight is organised and managed differently. The process of generating new ideas, both within and outside of R&D laboratories, creates a diversity of opinions about the value of these new ideas. Differences in the evaluation of new ideas, leads individual agents to pursue their commercialisation external to the established firm in the form of a new independent venture. The diversity of new ideas and experiments with their commercialisation manifests itself external as well as internal to incumbent firms. The selection between viable and non-viable ideas is then the result of the market process and not restricted to internal decisions imposed by decision-making hierarchies. The drive to appropriate the expected value of knowledge embodied in individual economic agents results in commercialisation of ideas in the form of new firms. But not all of these start-ups are successful. A large body of empirical studies shows (Geroski, 1994) that (1) start-up rates are greater in innovative industries than in non-innovative industries, and (2) the likelihood of survival is lower in innovative industries²⁸. Audretsch (1995) finds that one-third of all U.S. manufacturing firms are less than six years old. However, these new start-ups account for only 5 percent of total manufacturing employment. Taken together, this evidence provides a view of the entrepreneurial economy as being remarkably turbulent, in that a large number of firms are started each year, but only a few of the firms actually survive beyond a decade, and an even fewer number of those new firms grow sufficiently to challenge the incumbents.

It is not just enterprises that are more turbulent in the entrepreneurial economy, but also both jobs and the commitments between firms and workers. Davis, Haltiwanger and Schuh (1996) document a marked increase in the degree of worker turnover in the United States over a long period of time. At the same time, labour contracts have become more targeted towards specific tasks, typically for a limited period time, whereas in the managed economy labour contracts tended to be general for an indefinite time period. The new legal forms of employment contracts and practises, such as part-time workers, flex-workers, temporary workers, free lance workers, contract workers, consultants, represent the injection of entrepreneurial forces in the labour market. The greater degree of uncertainty and turnover experienced by workers in the entrepreneurial economy mirrors the greater turbulence experienced by firms. Replacing long-term fixed contracts with new flexible forms of work contracts provides the essential vehicle propelling the transition from the managed to the entrepreneurial economy.

2.5. Diversity versus Specialisation

There has been a series of theoretical arguments suggesting that the degree of diversity versus specialisation may account for differences in rates of growth and technological change. There are two dimensions to this debate -- the firm and the industry. More recently, it has been extended to geographic units, such as nations and regions. On the one hand, specialisation of industry activities is associated with lower transactions costs and therefore greater (static)

²⁸ For a study of the services see Audretsch, Klomp and Thurik (1997).

efficiency. On the other hand, a diversity of activities is argued to facilitate the exchange of new ideas and therefore greater innovative activity and (dynamic) efficiency.

One view, which Glaeser, Kallal, Scheinkman and Shleifer (1992) attribute to the *Marshall-Arrow-Romer* externality, suggests that an increased specialisation of a particular industry facilitates knowledge spillovers across firms because all workers are engaged in identical activity. This model formalises the insight that the concentration of an industry within a certain set of narrow economic activities promotes knowledge spillovers between firms and therefore facilitates innovative activity. An important assumption of the model is that knowledge externalities with respect to firms exist, but only for firms within the same activities.

By contrast, restricting knowledge externalities to occur only within the specialised industry may ignore an important source of new economic knowledge -- inter-industry knowledge spillovers. Jacobs (1969) argues that the most important source of knowledge spillovers are external to the industry in which the firm operates and that cities are the source of considerable innovation because the diversity of knowledge sources in cities are the greatest. This same view about the role of knowledge spillovers in cities is the basis of Lucas (1993). According to Jacobs, it is the exchange of complementary knowledge across diverse firms and economic agents which yields a greater return on new economic knowledge. She develops a theory that emphasises that the variety of industries within a geographic region promotes knowledge externalities and ultimately innovative activity and economic growth.²⁹

Because spillovers are an important source of knowledge generating innovative activity, diversity is a prerequisite of the entrepreneurial economy. Sacrificing lower transactions costs for greater opportunities for knowledge spillovers is preferable. In the managed economy, there is less to be gained from the spillover of knowledge. The higher transactions costs associated with diversity yield little in terms of increased innovative activity, making specialisation preferable in the managed economy.

2.6. Heterogeneity versus Homogeneity

A trade-off exists between the degree of heterogeneity and homogeneity within the population. There are two dimensions shaping the degree of homogeneity/heterogeneity. The first refers to the genetic make-up of individuals and their personal experiences (Nooteboom, 1994). The second dimension refers to the information set to which they are exposed. The managed economy is based on homogeneity; the entrepreneurial economy on heterogeneity.³⁰

To the extent that individuals in the population are identical, the costs of communication and transactions are minimised (Olson, 1982). Lower costs of transaction in communication result in (static) efficiency gains and facilitate a higher probability of knowledge spilling over across individuals within the population. However, new ideas are less likely to emerge from communication across individuals in a perfectly homogeneous population because these individuals tend to be identical. This means that individuals in homogeneous populations tend to

²⁹ The first important test of the specialisation versus diversity theories to date has focused not on the gains in terms of innovative activity, but rather in terms of employment growth. Glaeser, Kallal, Scheinkman and Shleifer (1992) employ a data set on the growth of large industries in 170 cities between 1956 and 1987 in order to identify the relative importance of the degree of regional specialisation, diversity and local competition play in influencing industry growth rates. The authors find evidence that contradicts the Marshall-Arrow-Romer model but is consistent with the theories of Jacobs. However, their study provided no direct evidence as to whether diversity is more important than specialisation in generating innovation.

³⁰ According to Nooteboom (1994, p. 330), "The sources that produce diversity within the scope allowed for it, lie in the variance of backgrounds, motives and goals of entrepreneurship." For an important exploration of the sources of diversity see Nooteboom (1994).

have access to the same information sets and to evaluate any information set in a similar fashion. Thus, a homogeneous population results in a higher probability of communications but those communications have a lower impact because there are fewer new ideas to spill over. A world of homogeneous economic agents promotes diffusion but not innovation.

In a heterogeneous population each individual has a unique genetic and experience profile, and has access to a unique information set (Olson, 1982). The unique genetic and experience profiles would result in a different evaluation across individuals even for a given set of information. However, a heterogeneous population is also characterised by differential access to information. This means that the costs of communications across individuals in a heterogeneous population tend to be difficult and costly, resulting in higher transactions costs and lower levels of efficiency than in a homogeneous population. At that same time, new ideas are more likely to emerge from communication in a heterogeneous than in a homogeneous world. An implication is that the likelihood of communication in a heterogeneous population is lower but are more prone to produce novelty and innovation. It is differences not similarities that generate knowledge spill over.

The trade-off between diversity versus specialisation focuses on the population of firms and industries. The trade-off discussed in this section is analogous and involves the population of people which involves the degree of heterogeneity versus homogeneity. The lower transactions costs resulting from a homogeneous population in the managed economy are not associated with a high opportunity cost, because knowledge spillovers are relatively unimportant in generating innovative activity. However, knowledge spillovers are a driving force in the entrepreneurial economy, which more than offset the higher transactions costs associated with a heterogeneous population.

2.7. Control versus Motivation

If the application of British inventions in the 1800s had served as the catalyst for U.S. industrialisation, the revolution in management techniques -- the modern corporate structure -- enabled its implementation. According to the former U.S. Secretary of Labour, Robert Reich (1983, p. 26), "Managerialism offered America a set of organising principles at precisely the time when many Americans sensed a need for greater organisation and these principles soon shaped every dominant American institution precisely as they helped those institutions become dominant. The logic of routine, large-scale manufacturing, first shaped its original business environment and then permeated the larger social environment."

Through the structure of the modern corporation, the new managerialism excelled at amassing large quantities of raw materials, labour and capital inputs, and at applying particular manufacturing processes, thereby achieving a very specific use of these resources. The essence of the managerialism was *command and control of labour effort*. Labour was considered to be indistinguishable from all other inputs, as long as scientific management was able to extract a full day's worth of energy for a full day's pay (Wheelwright, 1985). As tasks became increasingly specialised, the skill level required of workers under the mass-production regime became less important. What mattered most under Taylorism was the consistency and reliability of each precise cog; what mattered least was the decision-making capability of each unit. Thus, the labour input in the production process was reduced to routine (Chandler, 1990).

However, as the comparative advantage of the advanced industrialised countries in Europe and North America become increasingly based on new knowledge, the command and control approach to labour becomes less effective. What matters less is requiring an established set of activities from knowledge workers and what matters more is motivating the workers to facilitate the discovery and implementation of new ideas. The type of work environment

fostering creativity apparently is radically different from one simply harnessing the brute labour input of workers. This contrast between the new entrepreneurial and managed economies is reflected by the explosion of titles such as *Managing Chaos*, *Re-engineering*, *Management without Hierarchy*, and *De-Layering* in the popular management literature. Thus, in the entrepreneurial economy motivating employees to participate in the creation and commercialisation of new ideas matters more than in simply controlling and regulating their behaviour.

2.8. Market Exchange versus Firm Transaction

In the managed economy, transactions within firms tend to be more efficient than market exchange. This is consistent with the well documented increase in both vertical integration and conglomeration during the post-war period (Chandler, 1977). In the entrepreneurial economy, both of these trends have been reversed (Carlsson, 1989). As Carlsson and Taymaz (1994) show, there has been a decrease in both mean firm size as well as the extent of vertical integration and conglomeration since the mid-1970s.

Coase was awarded a Nobel Prize for explaining why a firm should exist. But why should more than one firm exist in an industry?³¹ One answer is provided by the traditional economics literature focusing on industrial organisation in the managed economy. An excess level of profitability induces entry into the industry. And this is why the entry of new firms is interesting and important in the managed economy -- because the new firms provide an equilibrating function in the market, in that the levels of price and profit are restored to the competitive levels. In the traditional theory, outputs and inputs in an industry are assumed to be homogenous. That is, the entry of new firms in the managed economy is about business as usual -- it is just that with the new entrant there is more of it. Geroski (1991a, p. 65) reflects the role of entry in the managed economy by asserting, "If we think of entry as an error-correction mechanism which is attracted by and serves to bid away excess profits, it is natural to suppose that entry will occur whenever profits differ from their long-run levels. Given this maintained hypothesis, observations of actual entry rates and current (or expected post-entry) profits can be used to make inferences about the unobservable of interest -- long-run profits. In particular, entry in an industry is hypothesised to occur whenever expected post-entry profits exceed the level of profits protected in the long run."

Empirical evidence in support of the model of entry in the managed economy is ambiguous at best.³² Perhaps one reason for this trouble is the inherently static model used to capture an inherently dynamic process.³³

³¹ Coase (1937, p. 23) himself asked, "A pertinent question to ask would appear to be (quite apart from the monopoly considerations raised by Professor Knight), why, if by organising one can eliminate certain costs and in fact reduce the cost of production, are there any market transactions at all? Why is not all production carried on by one big firm?"

³² This leads Geroski (1991b, p. 282) to conclude, "Right from the start, scholars have had some trouble in reconciling the stories told about entry in standard textbooks with the substance of what they have found in their data. Very few have emerged from their work feeling that they have answered half as many questions as they have raises, much less that they have answered most of the interesting ones."

³³ Manfred Neumann (1993, pp. 593-594) has criticised this traditional model of entry, as found in the individual country studies contained in Geroski and Schwalbach (1991), because they "are predicated on the adoption of a basically static framework. It is assumed that start-ups enter a given market where they are facing incumbents which naturally try to fend off entry. Since the impact of entry on the performance of incumbents seems to be only slight, the question arises whether the costs of entry are worthwhile, given the high rate of exit associated with entry. Geroski appears to be rather sceptical about that. I submit that adopting a static framework is misleading....In fact, generally, an entrant can only hope to succeed if he employs either a new technology or offers a new product, or both. Just imitating incumbents is almost certainly doomed to failure. If the process of entry is looked upon

In the entrepreneurial economy, the balance between market exchange and firm transactions leads to a different role for the entry of new firms. This is because the entrepreneurial economy is based more on the factor of new knowledge and less on the traditional factors of land, labour and capital upon which the managed economy thrived. There is an inherent difference between new knowledge and the traditional factors. As Knight (1921), and later Arrow (1962) emphasised, new economic knowledge is anything but certain. Not only is new economic knowledge inherently risky, but substantial asymmetries exist across agents both between and within firms. (Milgrom and Roberts, 1987). The expected value of a new idea, or potential innovation, is likely to be anything but unanimous between the inventor of that idea and the decision maker, or group of decision makers,³⁴ of the firm confronted with evaluating proposed changes or innovations.³⁵

Combined with the bureaucratic organisation of incumbent firms to make a decision, the asymmetry of knowledge leads to a host of agency problems, spanning incentive structures, monitoring, and transaction costs. It is the existence of such agency costs, combined with asymmetric information that not only provides an incentive for agents with new ideas to appropriate the expected value of their knowledge externally by starting new firms, but also with a propensity that varies systematically from industry to industry.³⁶

To minimise agency problems and the cost of monitoring, bureaucratic hierarchies develop objective rules.³⁷ As Holmstrom (1989, p. 323) points out, "Monitoring limitations suggest that the firm seeks out activities which are more easily and objectively evaluated. Assignments will be chosen in a fashion that are conducive to more effective control. Authority and command systems work better in environments which are more predictable and can be directed with less investment information. Routine tasks are the comparative advantage of a bureaucracy and its activities can be expected to reflect that."

from this perspective the high correlation between gross entry and exit reflects the inherent risks of innovating activities...Obviously it is rather difficult to break loose from the inherited mode of reasoning within the static framework. It is not without merit, to be sure, but it needs to be enlarged by putting it into a dynamic setting."

³⁴ For example, as of 1993 a proposal for simply modifying an existing product at IBM had to pass through 250 layers of decisionmaking to gain approval ("Überfordert und Unregierbar," *Der Spiegel*, No. 14, 1993, p. 127).

³⁵ It is because information is not only imperfect but also asymmetric that Knight (1921, p. 268) argued that the primary task of the firm is to process information in order to reach a decision: "With the introduction of uncertainty -- the fact of ignorance and the necessity of acting upon opinion rather than knowledge -- into this Eden-like situation (that is a world of perfect information), its character is entirely changed...With uncertainty present doing things, the actual execution of activity, becomes in a real sense a secondary part of life; the primary problem or function is deciding what to do and how to do it."

³⁶ Alchian (1950) pointed out that the existence of knowledge asymmetries would result in the inevitability of mistaken decisions in an uncertain world. Later, Alchian and Demsetz (1972) attributed the existence of asymmetric information across the employees in a firm as resulting in a problem of monitoring the contribution accruing from each employee and setting the rewards correspondingly. This led them to conclude that, "The problem of economic organisation is the economical means of metering productivity and rewards" (Alchian and Demsetz, 1972, p. 783). Coase (1937) and later Williamson (1975) argued that the size of an (incumbent) enterprise will be determined by answering what Coase (1937, p. 30) articulated as, "The question always is, will it pay to bring an extra exchange transaction under the organising authority?" In fact, Coase (1937, p. 24) pointed out that, "Other things being equal, a firm will tend to be larger the less likely the (firm) is to make mistakes and the smaller the increase in mistakes with an increase in the transactions organised."

³⁷ Holmstrom (1989) and Milgrom (1988) have pointed out the existence of what they term as a *bureaucratisation dilemma*, where, "To say that increased size brings increased profit is a safe generalisation. To note that bureaucracy is viewed as an organisational disease is equally accurate" (Holmstrom, 1989, p. 320). In addition, Kreps (1991) has argued that such bureaucratic rules promote internal uniformity and that a uniform corporate culture, in turn, promotes the reputation of the firm. These bureaucratic rules, however, make it more difficult to evaluate the efforts and activities of agents involved in activities that do not conform to such bureaucratic rules.

Williamson (1975, p. 201) has also emphasised the inherent tension between hierarchical bureaucratic organisations and the ability of incumbent organisations to appropriate the value of new knowledge for innovative activity outside of the technological trajectories associated with the core competence of that organisation, "Were it that large firms could compensate internal entrepreneurial activity in ways approximating that of the market, the large firm need experience no disadvantage in entrepreneurial respects. Violating the congruency between hierarchical position and compensation appears to generate bureaucratic strains, however, and is greatly complicated by the problem of accurately imputing causality." This leads Williamson (1975, pp. 205-206) to conclude that, "I am inclined to regard the early stage innovative disabilities of large size as serious and propose the following hypothesis: An efficient procedure by which to introduce new products is for the initial development and market testing to be performed by independent investors and small firms (perhaps new entrants) in an industry, the successful developments then to be acquired, possibly through licensing or merger, for subsequent marketing by a large multidivision enterprise...Put differently, a division of effort between the new product innovation process on the one hand, and the management of proven resources on the other may well be efficient."

The degree to which agents and incumbent firms are confronted with knowledge asymmetries and agency problems with respect to seeking out new economic knowledge and (potential) innovative activity would not be expected to be constant across industries. This is because the underlying knowledge conditions vary from industry to industry. In some industries new economic knowledge generating innovative activity tends to be relatively routine and can be processed within the context of incumbent hierarchical bureaucracies. In other industries, however, innovations tend to come from knowledge that is not of a routine nature and therefore tends to be rejected by the hierarchical bureaucracies of incumbent corporations. Nelson and Winter (1982) describe these different underlying knowledge conditions as reflecting two distinct technological regimes -- the entrepreneurial and routinized technological regimes: "An entrepreneurial regime is one that is favourable to innovative entry and unfavourable to innovative activity by established firms; a routinized regime is one in which the conditions are the other way around." (Winter, 1984, p. 297). As the comparative advantage of the advanced industrial economies shifts towards innovative industries, what is true for those industries holds for entire countries.³⁸

In the managed economy, there is likely to be relatively little divergence in the evaluation of the expected value of a (potential) innovation between the inventor and the decision making bureaucracy of the firm. A great incentive for agents to start their own firms will not exist. In the entrepreneurial economy, however, a divergence in beliefs between the agent and the principal

38 Gort and Klepper (1982) argued that the relative innovative advantage between newly established enterprises and incumbent firms depends upon the source of information generating innovative activity. If information based on non-transferrable experience in the market is an important input in generating innovative activity, then incumbent firms will tend to have the innovative advantage over new firms. This is consistent with Winter's (1984) notion of the routinized regime, where the accumulated stock of non-transferrable information is the product of experience within the market, which firms outside of the main incumbent organisations, by definition, cannot possess. By contrast, when information outside of the routines practised by the incumbent firms is a relatively important input in generating innovative activity, newly established firms will tend to have the innovative advantage over incumbent firms. Arrow (1962), Mueller (1976), and Williamson (1975) have all emphasised that when such information created outside of the incumbent firms cannot be easily transferred to those incumbent enterprises -- presumably due to the type of agency and bureaucracy problems described above -- the holder of such knowledge must enter the industry by starting a new firm in order to exploit the expected value of his knowledge.

regarding the expected value of a (potential) innovation is more likely to emerge.³⁹ It is in the entrepreneurial economy where the start-up of new firms is likely to play a more important role, presumably as a result of the motivation to appropriate the value of economic knowledge.

2.9. Competition and Co-operation as Substitutes versus Competition and Co-operation as Complements

In the managed economy competition and co-operation are viewed as being substitutes. This is because firms are vertically integrated and compete primarily in product markets. Co-operation between firms in the product market reduces the number of competitors and lessens the degree of competition. In the entrepreneurial economy firms are vertically independent and specialised in the product market. The greater degree of vertical disintegration in the entrepreneurial economy means that co-operation among independent firms replaces internal transactions within a large vertically integrated corporation. At the same time, there are more firms, resulting in an increase in both the competitive as well as the co-operative interface. The likelihood that a firm may end up competing or co-operating with another firm is greater in the entrepreneurial economy. In addition, new and enhanced configurations bring independent firms together in new and unexpected ways.

As Zvi Griliches (1992) has pointed out, knowledge spillovers come from different people working on similar things. A rich set of empirical evidence supports Griliches' conjecture in identifying that knowledge spillovers are promoted in clusters of economic activity (Audretsch and Feldman, 1996; and Audretsch and Stephan, 1996). Thus, co-operation between individuals as well as between different firms generates the spill over of knowledge and new ideas. There is a large incentive for individuals and firms to interact co-operatively to create and explore new ideas that would otherwise remain undiscovered.

At the same time, there is a high degree of competition among firms for new ideas. Knowledge, embodied in individuals and teams of individuals, which is not used by one firm will be pursued by another firm if it is perceived as valuable. Thus, there is a high degree of competition for new ideas by the very firms that are co-operating to create those ideas. In addition, the increased interaction of firms and individuals facilitates the rapid diffusion of new ideas and the outcome of efforts to generate new ideas across individuals in different firms as well as within firms. In the managed economy, the monopolisation of information was typically associated with power: "Information is power" and is to be shared sparingly seemed to be the practice within large organisations such as IBM and Philips Electronics.

In studying the networks in California's Silicon Valley, Saxenian (1990, pp. 96-97) emphasises that it is the co-operation between individuals which facilitates the transmission of knowledge across agents, firms, and even industries, and not just a high endowment of human capital and knowledge in the region: "It is not simply the concentration of skilled labour, suppliers and information that distinguish the region. A variety of regional institutions -- including Stanford University, several trade associations and local business organisations, and a myriad of specialised consulting, market research, public relations and venture capital firms -- provide technical, financial, and networking services which the region's enterprises often cannot afford individually. These networks defy sectoral barriers: individuals move easily from semiconductor to disk drive firms or from computer to network makers. They move from established firms to start-ups (or vice versa) and even to market research or consulting firms, and from consulting firms back into start-ups. And they continue to meet at trade shows, industry

³⁹ In the framework of Hirschman (1970), if an agent in possession of potentially valuable economic knowledge is unable to exercise voice within an existing firm, only loyalty will prevent him from exercising exit by starting a new firm.

conferences, and the scores of seminars, talks and social activities organised by local business organisations and trade associations. In these forums, relationships are easily formed and maintained, technical and market information is exchanged, business contacts are established, and new enterprises are conceived...This decentralised and fluid environment also promotes the diffusion of intangible technological capabilities and understandings."⁴⁰

Thus, in the managed economy increasing the amount of co-operation reduces the degree of competition. There are simply fewer rivals competing in the product market. In the entrepreneurial economy, both competition and co-operation exist simultaneously. An increase in competition may actually generate an increase in co-operation in the search for knowledge spillovers.

2.10. Flexibility versus Scale

The classic manner for reducing cost-per-unit in economics under the managed economy was through expanding the scale of output, or through exploiting *economies of scale*. In product lines and industries where a large scale of production renders a substantial reduction in average cost, large firms will have an economic advantage, leading to a concentrated industrial structure. The importance of scale economies no doubt contributed to the emergence and dominance of large corporations in heavy manufacturing industries such as steel, automobiles, and aluminium (Chandler, 1977).

The alternative source of reduced average costs under the entrepreneurial economy is through flexibility. As Teece (1993, p. 218) argues, "Flexible specialisation ... and contracting may today yield greater advantages than economies of scale and scope generated internally." Industries where demand for particular products is constantly shifting requires a flexible system of production that can meet such a shifting demand. There are four major sources of flexibility – technological, organisational, demand side and qualitative. These four sources of flexibility result in a decrease in the importance of scale economies. The popular press has been filled with examples of how scale economies are being replaced by smaller-scale flexible production. According to management consultant Tom Peters, "Old ideas about economies of scale are being challenged...Scale itself is being redefined. Smaller firms are gaining in almost every market, at least in America. Even Peter Drucker, father of modern big-firm management, now advocates the 'mid-size' company. The tiniest firm can usually do some activity -- from plant watering to specialised legal services -- better than a giant. So we see a spreading trend toward deintegration and subcontracting."⁴¹

Technological flexibility refers to the emergence of certain new technologies, such as computer numerically controlled machine tools which facilitates flexible production. Systematic attempts to estimate the impact of these new technologies on the extent of scale economies (Carlsson, 1989; Carlsson and Taymaz, 1994) have resulted in the conclusion that the importance of scale economies has been drastically reduced in industries where such flexible technology has been implemented.

The second manifestation of flexibility is in terms of the organisation of production. While the organisation of production was centred upon mass-production during the first three decades of this century, an alternative system of industrial organisation, flexible specialisation has seen something of a re-emergence during the last several decades of this century (Piore and

⁴⁰ Saxenian (1990, pp. 97-98) claims that even the language and vocabulary used by technical specialists is specific to a region, "...a distinct language has evolved in the region and certain technical terms used by semiconductor production engineers in Silicon Valley would not even be understood by their counterparts in Boston's Route 128."

⁴¹ Tom Peters, "New Products, New Markets, New Competition, New Thinking," *The Economist*, 4 March, 1989, pp. 27-32.

Sabel, 1984). Flexible production consists of producing smaller series of specially designed goods of a specific quality for a niche market. Such goods typically command a higher price and cannot be so easily diffused to lower-cost production locations. The organisation of industry centred around flexible specialisation typically contains five key elements:

1. *A reliance upon multi-purpose equipment.* General purpose equipment enhances the flexibility to rapidly change the product specifications to meet specific demands of customers. This requires high levels of human capital and skilled labour.

2. *Continual innovative activity.* Both the nature of the product(s) as well as production and organisation methods are continually improved upon.

3. *Clustering.* Groupings of enterprises, in both a product as well as a geographic dimension provide a seedbed for the exchange of new ideas. Not only does physical proximity tend to facilitate the transmission of knowledge, but it also enhances the development of institutions and makes them more effective.

4. *Networking.* Formal and informal links between enterprises, including subcontracting relationships facilitate both increased economic specialisation external to the firm as well as superior access to information.

5. *Spillover Effects.* Knowledge created within an enterprise spills over for use by other enterprises. Conversely, enterprises and individuals have access to external knowledge.

There is considerable evidence supporting the hypothesis that not only does flexible production provide a viable alternative to mass production as a system of industrial organisation, but also that such systems centred around flexible production actually outperform those based on mass production. This evidence spans both developed and less developed countries.⁴²

The third type of flexibility refers to the ability of production to absorb demand fluctuations (Mills, 1984). There is a trade-off between efficiency, as measured by the costs of producing a given level of output, on the one hand, and flexibility, as measured by the costs of adjusting output, on the other hand. Large firms with high capital investment achieve a larger scale of output at a lower marginal cost than do small enterprises which are labour intensive. But the labour intensity of small firms enables them to adjust their current level of output at lower cost than their larger counterparts, which are capital and not labour intensive. As Brock and Evans (1989, p. 10) summarise, "Smaller firms incur higher marginal production costs at a point in time than a larger firm but include lower marginal adjust costs over time as demand fluctuates."

The fourth type of flexibility refers to the ability for economic activity to respond to qualitative changes in market demands. In a world of wealth and affluence, consumer demand is heterogeneous and fickle. Demand tends to proliferate across a broad spectrum of product class niches. The variances in consumer demand across product types and over time creates a continuously changing set of product niches. Knowledge about these niches is uncertain for two reasons. First, the niches are difficult to observe and other changing. Second, the set of economic agents evaluating potential opportunities are heterogeneous. These two knowledge conditions

⁴² One of the most striking examples of superior economic performance emerging from the industrial organisation model of flexible production is provided by Emilia Romagna, a mixed agricultural-industrial region located in North Central Italy with a population of around four million, and usually referred to as *The Third Italy*. Through flexible production small firms have achieved a better economic performance than large enterprises by creating specialised industrialised districts where an agglomeration of producers in one industry work in close physical proximity. In what has become known as the *Emilian Model of Production*, the narrow division of labour common to large enterprises has been replaced by an organisational structure where employees perform a wide variety of different tasks (Piore and Sabel, 1984).

are pivotal for understanding the entrepreneurial economy. This means that people are confronted with a variance in evaluations about the relevance of opportunities of the prospective ventures and, hence, the relevance of possible actions. That is, significant differences in the evaluations of future demand exist across associated with high costs of transactions, some individuals will perceive opportunities where others do not. Individuals who seek to appropriate the value of such knowledge by starting a new firm serve as *agents of change* by injecting flexibility into the economy. A common myth is that small firms are more flexible than large firms. The mistake is committed at the unit of observation – the firm. Rather, the empirical evidence suggests that a population of firms, or an organisation of industry consisting of diverse new and small firms provides greater flexibility than does an organisation of industry consisting of large corporations.

Scale economies were the engine that drove efficiency and growth in the managed economy. In the entrepreneurial economy the multiple dimensions of flexibility replace scale economies as the organising principle for economic activity.

2.11. Change versus Continuity

Cohen and Klepper (1992) identify an inherent trade-off between change on the one hand and continuity on the other. While the managed economy depended upon continuity (Chandler, 1977), the entrepreneurial economy provokes and thrives on change. Cohen and Klepper's (1992) theory extends the work of Richard Nelson (1981) about the importance of competition and diversity for technological change. Seen through the lens of evolutionary economics (Nelson and Winter, 1982) there are two key dimensions involved in the process of technological change -- diversity and selection. The technological competence of each firm results in a particular technological trajectory. Innovative activity is generally within the boundaries established by the firm's core competence and its technological trajectory. Such innovative activity within the technological paradigm established by the firm's core competence provides the basis of continuity in the managed economy.

As Cohen and Klepper (1992) point out, large firms have a greater incentive to invest in R&D because they are better able to appropriate the returns through greater output and sales. At the same time they do not have a large incentive to try to extend innovative activity beyond the boundaries imposed by their technological trajectories. According to Cohen and Klepper (1992, p. 2), "Dividing up industry output over a greater number of small firms increases the chances that any given approach to innovation will be pursued, thereby increasing the diversity of technological efforts in the industry. While increasing the number of firms does not necessarily benefit individual firms in the industry, it promotes technical advance and, hence, benefits society by increasing the number of productive approaches to innovation that are collectively pursued in the industry. From this perspective, the source of the social advantage associated with small firm size is not smallness per se but the greater number of firms that small size implies given some industry demand." Thus, in the entrepreneurial economy, decentralised decision-making in an industrial structure comprised of smaller firms leads to a greater diversity of approaches. This diversity, in turn, generates greater opportunities for breaking out of the boundaries imposed by the lock-in along technological trajectories and ultimately to hit it big.

Concentrating knowledge resources in just several firms in the managed economy results in a concentration of innovative activity within just several technological trajectories. By contrast, unleashing knowledge by letting loose a horde of independent agents – deconcentration -- in the entrepreneurial economy, results in a greater diversity of approaches across a broad range of technological trajectories. Which is more efficient? If the degree of uncertainty is relatively low, then concentrating knowledge results may result in greater technological change.

But as the degree of uncertainty increases, a diversity of approaches, represented by a multiplicity of technological trajectories, becomes more important.

2.12. *Stimulation versus Regulation*

The public policies emerging in the post-war period of the managed economy dealing with the firm in the market were essentially constraining in nature. There were three general types of public policies towards business -- antitrust (competition policy), regulation, and public ownership. All three of these policy approaches restricted the firm's freedom to contract. While specific policy approaches tended to be more associated with one country than with others, such as antitrust in the United States, or public ownership in France and Sweden, all countries shared a common policy approach of intervening to restrain what otherwise was perceived as too much market power held by firms.

Public policies constraining the freedom of the firm were certainly consistent with the *Weltanschauung* emerging from the theories and empirical evidence. Left unchecked, the large corporation in possession of market power would allocate resources in such a way as to reduce economic welfare. Through state intervention the trade-off between efficiency on the hand and fairness on the other would be solved in a manner that presumably would be more socially satisfying. Galbraith (1956) is the seminal statement on the role of government in the managed economy, where state intervention typically involved the social partnership of big business, big government and big labour. This social partnership existed in nearly every Western economy.

In the entrepreneurial economy the relevant policy question has shifted away from *How can the government constrain firms from abusing their market power?* to *How can governments create an environment fostering the success and viability of firms?* The major issues in the entrepreneurial economy have shifted away from concerns about excess profits and abuses of market dominance to international competitiveness, growth and employment. The concern about corporations is not that they are too successful and too powerful but that they are not successful enough. Jorde and Teece (1991) argued for the emasculation of the antitrust laws in order to enable American firms to co-operate and compete more effectively against their Japanese and European competitors.

As the waves of small start-ups in newly emerging high-technology industries demonstrate, the link between success and market power has been broken. The government policies of the entrepreneurial economy have increasingly shifted away from regulation to stimulation. Examples include the promotion joint R&D programs, fostering efforts to innovate and the creation of new firms. As unemployment in Germany surpassed four million, and stood at 10.8 percent of the labour force, it is not surprising that Chancellor Helmut Kohl would undertake action to spur the creation of new jobs. What is more surprising is the main emphasis announced by the Chancellor in the *Initiatives for Investment and Employment*⁴³ on January 30, 1996 on new and small firms. The first and main point of this program consists of a commitment to the "creation of new innovative firms."⁴⁴ The rationale underlying this commitment by the Chancellor is stated in the Program: "New jobs are created mainly in new firms and in small- and medium-sized enterprises."⁴⁵ This *Weltanschauung* apparent in this Kohl jobs program

⁴³ This was announced as the *Aktionsprogramm für Investitionen und Arbeitsplätze* ("Soziale Einschnitte und Steuerreform sollen Wirtschaftswachstum anregen: Bundesregierung beschließt Aktionsprogramm für Investitionen und Arbeitsplätze," *Der Tagesspiegel*, 31 January, p. 1).

⁴⁴ The original text of the *Aktionsprogramm* states, "Offensive für unternehmerische Selbständigkeit und Innovationsfähigkeit" ("Ein Kraftakt zu Rettung des Standorts Deutschland," *Frankfurter Allgemeine*, 31 January, 1996, p. 11).

⁴⁵ *Ibid.* The original text reads, "New Arbeitsplätze entstehen zumeist in neugegründeten Unternehmen und im Mittelstand".

represents an attempt to shift Germany away from a managed economy and towards an entrepreneurial economy.

2.13. Targeting Inputs versus Targeting Outputs

Stimulation and regulation are not the only dimensions regarding the role of government policy in the managed and entrepreneurial economies. A second dimension involves targeting selected outputs or outcomes in the production process versus targeting selected inputs. Because of the relative certainty regarding markets and products in the managed economy, the appropriate policy response is to target outcomes and outputs. Specific industries along with particular firms could be promoted through government programs. The targeting of specific firms in selected industries was clearly a successful policy for Japan in the post-war period and helped the Japanese achieve the competitive advantage in industries such as automobiles and electronics (Audretsch, 1989).

Targeting outputs has had a long tradition in Europe. As a response to “The American Challenge,” in the form of the dynamism, organisation, innovation, and boldness that characterise the giant American corporations,” Servan Schreiber (1968, p. 153) prescribed an R&D policy that would undertake “the creation of large industrial units which are able both in size and management to compete with the American giants”. Because giant corporations were thought to be needed to amass the requisite R&D resources for innovation, Servan-Schreiber (1968, p. 159) argued that “The first problem of an industrial policy for Europe consists in choosing 50 to 100 firms which, once they are large enough, would be the most likely to become world leaders of modern technology in their fields. At the moment we are simply letting industry be gradually destroyed by the superior power of American corporations.” This R&D policy prescription of targeting outputs is echoed in the 1988 Cecchini Report to the Commission of the European Union, where the anticipated gains from European integration are measured in terms of reduced costs achieved through increases in scale economies when firms are no longer limited to domestic markets and can instead operate on a larger European market.

How relevant are targeting outputs and outcomes today? One has to wonder what would have happened to the United States computer semiconductor industry had IBM been selected as “a national interest” around 1980 and promoted through favourable treatment as well as protected from threats like Apple Computer, Microsoft, and Intel. Would the United States be as strong in the computer, semiconductor, and software industries as it is today? While the proclamation, “What is good for General Motors is good for America” may have been sensible in the managed economy, it no longer holds in the entrepreneurial economy.

The entrepreneurial economy is based less on the traditional inputs of land, labour and capital, and more on the input of knowledge. It is no longer certain what products should be produced, how they should be produced, and by whom. This increased degree of uncertainty increases the difficulty of selecting the correct outcomes and increases the likelihood that the wrong firm and industry will be targeted. Rather, the appropriate policy in what Paul Krugman (1994) terms as *The Age of Uncertainty* is to target inputs, and in particular those inputs involved in the creation and commercialisation of knowledge. Such policies involve basic and applied research at universities and research institutes, investments in the general level of education as well as advanced technical specialities, and the training and upgrading of the skill levels of workers. While outcomes and outputs in the form of specific industries and even firms are targeted in the managed economy, the entrepreneurial economy calls for policy that creates an environment, or *Rahmenbedingungen*, facilitating the creation and commercialisation of knowledge.

2.14. Local Policy versus National Policy

The rationale and target of policy – stimulation versus control and inputs versus outputs – are not the only aspects to differ between the managed and entrepreneurial economies. A third dimension involves the locus of policy. Under the managed economy, the appropriate locus of policy making is at the national or federal level. While the targeted recipients of policy may be localised in one or a few regions, the most important policy making institutions tend to be at the national level. By contrast, under the entrepreneurial economy, the locus of government policy towards business tends to be decentralised and regional in nature.

In the managed economy, a federal or national locus of control of large, oligopolistic firms in command of considerable market power is appropriate. This is because the benefits and costs derived from that market power are asymmetric between the local region where the firm is located and the national market, where the firm sells its product. Not only is production concentrated in one or just several regions, but the workers along with ancillary suppliers also tend to be located in the same regions. These workers as well as the community at large, share the fruits accruing from monopoly power. Systematic empirical evidence (Weiss, 1966) shows that wages are positively related to the degree of market power held by a firm, even after controlling for unionisation. Higher profits resulting from market power are shared by labour. Workers and firms in their region have the same interest.

As Olson (1982) shows, relatively small coalitions of economic agents benefiting from some collective action tend to prevail over a large group of dispersed economic agents each incurring a small cost from that action. The costs of organising and influencing policy are relatively low for the small coalition enjoying the benefits but large for the group of dispersed economic agents. Government policies to control large oligopolistic firms with substantial market power are not as likely to be successful if they are implemented on the local level. Rather, as Olson (1982) predicts, a regional locus of policy towards business in the managed economy tends to result in the capture of policy by the coalition of local interests benefiting from that policy. Only by shifting the locus of policy away from the region to the national level can the capture of policy by special interest groups be minimised. This is because the negative effects of market power in the form of higher prices are spread throughout the national market while the benefits accruing from that power are locally concentrated.

The most important institutions administering antitrust policy and regulation, which were given the mandate by the United States Congress to constrain the market power of big business during the era of the managed economy, were at the national level. Beginning with the Sherman Act of 1890 and the Interstate Commerce Act of 1890, which established the first federal regulatory agency, the mandate for the control of large oligopolistic enterprises with substantial market power was mainly at the level of the federal government (Audretsch, 1989). The Antitrust Division of the United States Justice Department combined with the Federal Trade Commission to safeguard America against the abuse of market power, while a broad range of federal regulatory agencies, starting with the Interstate Commerce Commission and later the Federal Communications Commission and the Civil Aeronautics Boards were created to regulate large, oligopolistic firms in concentrated markets. But starting in the Carter Administration of the late 1970s and continuing into the Administrations of Presidents Reagan, Bush and Clinton, antitrust has been de-emphasised and a twenty year wave of deregulation has led to a downsizing and even closure of a number of the former regulatory agencies.

Many economists interpret the downsizing of the federal agencies charged with the regulation of business as the eclipse of government intervention. But to interpret the retreat of the federal government as the end of government intervention is to confuse the downsizing of government with a reshifting of the locus of government policy away from the federal level to

the local level. The last two decades have seen the emergence of a set of policy initiatives at the local level. The new industrial policy of the entrepreneurial economy is decentralised and regional in nature. As Sternberg (1996) emphasises in his review of successful technology policy in the four leading technological countries, the most important industrial policies in the last decades have been local not national. They have occurred in locations such as Research Triangle (Link, 1995), Austin Texas, and Cambridge (UK). Sternberg (1996) shows how the success of a number of different high-technology clusters spanning the four most technologically advanced countries is the direct result of regional policy.

This shift in the locus of policy is the result of two factors. First, because the competitive source of economic activity in the entrepreneurial economy is knowledge, which tends to be localised in regional clusters, public policy requires an understanding of regional-specific characteristics and idiosyncrasies. As Sternberg (1996) concludes, regional strengths provide the major source of innovative clusters. The second factor is that the motivation underlying government policy in the entrepreneurial economy is growth and the creation of (high-paying) jobs, largely through the creation of new firms. These new firms are typically small and pose no oligopolistic threat in national or international markets. There are no external costs imposed on consumers in the national economy in the form of higher prices as is the case in the managed economy. There is no reason that the promotion of local economies imposes a cost on consumers in the national economy, so that local intervention is justified and does not result in any particular loss incurred by agents outside of the region.

2.15. Risk Capital versus Low-Risk Capital

In the managed economy, the systems of finance in Europe have provided the existing companies with liquidity for investment.⁴⁶ This is particularly true in countries such as Germany, where the banks are allowed to hold equity positions in private companies (Cable, 1985). Many scholars have argued that allowing bank ownership of private companies has given Germany a superior mechanism linking finance to production (Edwards and Fischer, 1994; Mayer and Alexander, 1990). The evidence suggests this was true as long as Germany's comparative advantage was in traditional industries, such as automobile production, machine tools and metalworking (Audretsch and Elston, 1997). But as the comparative advantage in the European Union shifts away from managed industries towards entrepreneurial activities the demand for finance also shifts away from financing investment in traditional industries towards high-risk ventures. This means that, under the entrepreneurial economy, the traditional means of finance are not longer appropriate. Of particular importance is venture capital, which has traditionally been a form of finance for high-risk innovative new firms and the informal capital market (Gaston, 1989). Informal risk capital is equity and near-equity invested by private individuals directly, that is informally, without formal intermediation (Mason and Harrison, 1997). Near equity investments refer to loans or loan guarantees provided by individuals to firms where the individuals hold an equity. This has been referred to in the finance literature as informal debt or informal risk capital. Such informal risk capital is virtually the only source of risk or venture-type capital for most SMEs, once their capital needs surpass family resources (Hughes, 1997). As Gaston points out, "Informal capital markets are the leading sources of external source of external risk capital fuelling entrepreneurial start-ups and small business growth" (Gaston, 1989, p. 223).

⁴⁶ For a very thorough analysis on finance, see Hughes and Storey (1994), Storey (1994), and the special issues of *Small Business Economics* devoted to *European SME Financing* (Cressy and Olofsson, 1997), and to *Financing and Small Firm Dynamics* (Reid, 1996).

Because the availability of venture capital and informal capital varies substantially across countries, new ventures flourish where they have the easiest access to finance. For example, the institution of venture capital is considerably more developed in the United States than in Europe. And the manner in which that venture capital is used also varies between Europe and the United States. As *Newsweek* observes, “So alien is venture capital in Europe that the term itself is something of a misnomer.”⁴⁷ In 1994 only about five percent of European venture capital -- \$245 million-- was allocated towards start-up companies. This is actually a decrease of over 50 percent from 1988. By contrast, in the United States, there was \$750 million of investment, representing one-quarter of the total venture capital market, in new-firm start-ups. As a result, equity investment in small firms in new industries is slow to develop in Europe. Although the stock market established a regulated bourse for small firms in 1987, only seven small companies floated shares in 1993 and just four companies floated shares in 1994. Venture capitalists are rare, in part because they cannot sell their stakes on the stock market.”⁴⁸

The deficiency of venture capital and informal capital has impeded restructuring in the form of a liquidity constraint to people seeking finance to start a new company in a new industry. As *Newsweek* points out, “Few doubt that Europe’s current technological problem is intimately linked to its glaring lack of a deep venture-capital market. It is, in the mind of critics, the most damning evidence of a risk-averse economic culture. Simply put, bright men and women with good ideas have a hard time finding financiers to back them.”⁴⁹ According to Helmuth Guembel, who is the research director of the Gartner Group in Munich, “Put Bill Gates in Europe and it just wouldn’t have worked out.”

The entrepreneurial economy requires a system of finance different from that in the managed economy. Since the managed economy was based on certainty in outputs as well as inputs, a strong connection between banks and firms fostered growth. Certainty has given way to uncertainty in the entrepreneurial economy, so that financial institutions must also change.

3. Empirical Evidence

As we have seen above there are many consequences of the shift from a managed economy to the entrepreneurial one. Probably, there are many more consequences than the ones mentioned. For instance, a qualitative change in the demand for consultancy inputs will occur as a consequence of this shift. The basic question is whether, at the end of the day, the entrepreneurial economy leads to more economic growth than the managed one. Clearly, this question neglects the various specific roles of the trade-offs as we have dealt with above. The trade-offs themselves are not meant to be interpreted as determinants of economic growth. At most they are indicators of phenomena like shifts in innovative activity, employment, wage rate, market dynamics, propensity to export, etc. which can be growth determinants.

Considering the economic growth in European countries, we observe different patterns. One part of these differences is due to countries being in different stages of the business cycle. Another part is due to specific institutional, historical, political and social circumstances. The question is whether there is a third part due to the stage of their transition from the managed form to the entrepreneurial form of their economy .

In order to test whether we are able to decompose economic growth into these three components we have to define the entrepreneurial stage of the economy as well as growth. For growth we simply take that of the real gross national product. The definition of the

⁴⁷ “Where’s the Venture Capital?” *Newsweek*, 31 October, 1994, p. 44.

⁴⁸ “German Innovation: No Bubbling Brook,” *The Economist*, 10 September 1994, pp. 75-76.

⁴⁹ *Ibid.*

entrepreneurial stage of the economy is less straightforward. It is tempting to use the growth of the number of self-employed. The number of self-employed, however, is a notoriously difficult variable (*European Observatory*, 1993, 1994, 1995 and 1996), since the definitions throughout the European countries vary widely and attempts to synchronise them lack a convincing status. Moreover, it is not available for a large enough number of European countries. That is why we try to capture the stage of the transition using the annual percentage growth of value-of-shipments of small- and medium-sized firms minus the annual percentage growth of value-of-shipments of large firms.

We realise that there are more ways for entrepreneurship to contribute to growth than through smallness. Recent studies on the role of competition (Nickel, 1996), of deregulation (Koedijk and Kremers, 1996) and of the nature of innovation (Cohen and Klepper, 1996 and Hagedoorn, 1996) support this view. There may be something like an entrepreneurial climate which affects also large firms and governmental institutions (Wennekers, Thurik, Buis, 1997). But since what happens within these latter contexts is bound to correlate with the world of smallness, it seems justified to use the smallness indicator introduced above.

In order to link stage of transition to economic growth we use data provided by the *European Observatory* (1993, table 2.13, 1994, table 2.18 and 1995, various tables) and by the *OECD Economic Outlook* (1994). We measure the annual percentage growth of real gross national product, the annual percentage growth of value-of-shipments of small- and medium-sized firms (with employment less than 500 employees), as well the annual percentage growth of value-of-shipments of large firms (with employment of at least 500 employees), for three distinct time periods: 1988-1990, 1989-1992 and 1990-1993 for all twelve old member countries of the European Union (*Europe-12*). By old, we mean before Austria, Finland, and Sweden joined the Union. The country-year observations are divided into six groups on the basis of the degree to which value-of-shipments has shifted from large to small firms. For each group, the average percentage growth of GNP is computed. Table 1 relates these percentage growth rates to the relative shift in economic activity from large to small firms for each of the six groups. Those groups experiencing a greater shift in economic activity towards small firms have also achieved higher growth rates.

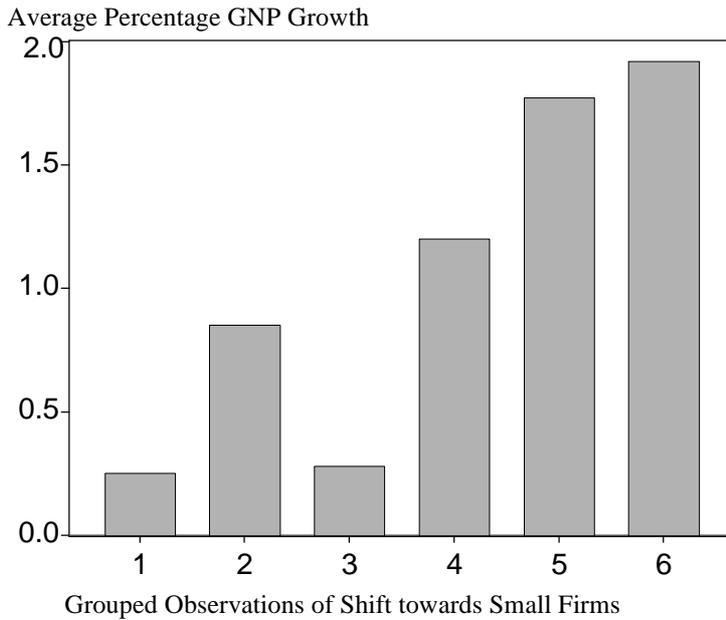


Figure 1: Growth and the Relative Shift towards Small Firms

The second data set is available for sixteen European countries (*Europe-16*) for the periods 1991-1993 and 1994. These sixteen countries are the fifteen member countries of the current European Union including Norway, a country which chose not to join. In this second data set small- and medium-sized firms are firms employing between 10 and 500. Using these data we link the percentage change in gross national product of each country, ΔGNP , to the stage of the transition from a managed economy to a entrepreneurial one, as represented by the percentage change in the value-of-shipments accounted for by small firms, ΔSF , minus the percentage change in the value-of-shipments accounted for by large firms, ΔLF , so that

$$\Delta GNP_{cp} = \sum_{c=1}^C {}_c D_c + \sum_{p=1}^P {}_p D_p + (\Delta SF_{cp-1} - \Delta LF_{cp-1}) + \Delta GNP_{cp-1}$$

where D_c and D_p denote two vectors of dummy variables referring to countries $c = 1, \dots, C$ and periods $p = 1, \dots, P$. These dummy variables are used because countries experience different stages of the business cycle at different points in time, and because country specific institutional, historical, political, and social factors are bound to influence economic growth. Clearly, less than $C + P$ dummy variables are used while computing the regression statistics to avoid full multicollinearity. The contribution of the shift of the size class structure of firms to the percentage growth of GNP is represented by $(\Delta SF_{cp-1} - \Delta LF_{cp-1})$. The influence of this shift on GNP growth is supposed to be lagged. The data used for GNP growth refer to the "succeeding" years 1991, 1993 and 1994 in the first data set and 1994 and 1995 in the second.

Our equation also includes lagged GNP growth in order to correct for the strong autocorrelation of GNP growth over time. By and large, no vehement cyclical fluctuations occurred in the European economies in the period we investigate. This might cause autocorrelation. Moreover, small firms turnover is probably more procyclical than large firms turnover. The small firms part of the economy has a different sectoral composition, has a higher domestic orientation and a lower strategic orientation than the large firm sector. If GNP increases (decreases) lagged GNP will increase (decrease) and small firms are more (less) likely to grow

than large firms. If ΔGNP_{cp-1} is left out of the regression equation, coefficient β will become positive because of this cyclical effect. This has nothing to do with the structural effect of the size class shift influencing GNP growth we are looking for. That is why lagged GNP growth is used in the regression equation and β can be interpreted as the 'mean' degree of autocorrelation of GNP growth in the countries of the European countries. Factors specific to each country influencing economic growth, other than the shift in economic activity between large and small firms, are reflected by γ , while factors specific to each time period are reflected by δ .

Two separate sets of regression results are obtained using the two data sets. The first data set consists of a total of 36 (12 countries times three periods) observations. However, two outliers had to be omitted in the period 1988-1990. The growth in value-of-shipments exhibited by large firms in Spain was exceptionally high and that in Denmark exceptionally low. In *Enterprises in Europe* (1995) it is reported that data for these two countries cannot be used for this period. The remaining 34 observations are used for computing the regression coefficients. The only dummy variable with a significant contribution is D_{1994} . This is easy to understand in view of the unexpectedly high jump in GNP growth in 1994. Weighting with the number of active population and using dummy variable D_{1994} only, we find that β equals 0.308 with a standard error of 0.166 and that γ equals 0.448 with a standard error of 0.167. The second data set consists of a total of 32 (16 countries times two periods) observations. Here it is not useful to compute β because GNP data for 1995 are forecasts and δ approaches one. The only dummy variable in the second regression with a significant contribution is D_{1995} . Weighting with the number of population and using this dummy variable only, we find that β equals 0.379 with a standard error of 0.158.

An important qualification to these results is that the data are new and have been constructed for the first time ever. Also, they include a number of estimates. Moreover, the regression results are sensitive to modification of specification. Follow-up studies are required for corroboration of these results⁵⁰. Still, β is found to be positive in both computations: it has a t-value of 1.9 in the period 1991-1994 for *Europe-12* and one of 2.4 in the period 1994-1995 for *Europe-16*. We have to conclude that, based on the findings of this exercise, there is at least some evidence suggesting that a shift in economic activity away from large firms and towards small enterprises is a catalyst for economic growth, at least for member countries of the European Union over a recent time period⁵¹. Since our interpretation is that this shift is an indicator of the stage of the transition of the economy from a managed one to an entrepreneurial one, we conclude that those European countries which are furthest on this transition track are rewarded with additional growth.

⁵⁰ Carree and Thurik (1998) provide a complementary analysis showing the consequence of lagging behind in this restructuring process in manufacturing. Using a sample of 14 manufacturing industries in 13 European countries they find that, on average, the employment share of large firms in 1990 has a negative effect on growth of output in the subsequent four-year period

⁵¹ Complementary evidence is provided by Schmitz (1989) and Nickell (1996). Schmitz presents an theoretical endogenous growth model which relates entrepreneurial activity and economic growth. He shows that an increase of the proportion of entrepreneurs in the working force leads to an increase in long-run economic growth. Nickell studies the effect of competition on the development of productivity of firms. He finds that an increased number of competitors is associated with higher rates of total factor productivity growth.

4. Conclusions

The continued rising unemployment coupled with stagnant growth in Europe has triggered a plea by policy makers for rethinking the policy approach that ushered in European prosperity during the post-war era. Those countries that have succeeded in creating new jobs and reducing unemployment seem to have accomplished this at the cost of lower wages and deterioration of a civil society. The resulting policy debate has been miscast as the European Model versus the American Model. This debate is wrong because it confuses a fundamental shift in economic systems with what used to be a recognised and widely accepted policy trade-off. If higher wages can only be gained at the cost of fewer jobs, how could the average income in Silicon Valley be fifty percent greater than in the rest of the country and still have created 15 percent more jobs between 1992 and 1996? And how could the Dutch have reduced unemployment in recent years without a significant decrease in the level of wages? The answer suggested in this paper is that the policy debate has been erroneously couched in terms of a dying economic system, which presented policy makers with trade-offs where, under the emerging economic system, no such trade-offs actually exist. The policy debate should be instead cast as the entrepreneurial versus the managed economy.

The managed economy flourished for most of this century. It was based on relative certainty in outputs, which consisted mainly of manufactured products, and in inputs, which consisted mainly of land, labour and capital. The twin forces of globalisation have reduced the ability of the managed economies of Western Europe and North America to grow and create jobs. On the one hand has come the advent of new competition from low-cost but relatively high educated and skill-intensive countries in Central and Eastern Europe as well as Asia. On the other hand, the telecommunications and computer revolutions have drastically reduced the cost of shifting not just capital but also information out of the high-cost locations of Europe and into lower-cost locations around the globe. Taken together, these twin forces of globalisation mean that economic activity in a high-cost location is no longer compatible with routinised tasks. Rather, globalisation has shifted the comparative advantage of high-cost locations to knowledge-based activities, and in particular search activities, which cannot be costlessly transferred around the globe.

Knowledge as an input into economic activity is inherently different from land, labour and capital. It is characterised by high uncertainty, high asymmetries across people and is costly to transact. The response to an economy where knowledge is the main source of comparative advantage is the entrepreneurial economy. This paper has identified fifteen characteristics that differ between the entrepreneurial and managed economies and provides a framework for understanding how the entrepreneurial economy fundamentally differs from the managed economy. Such a framework provides a lens through which to interpret economic events and formulate policy. Application of the wrong lens leads to the wrong policy choice. For example, under the managed economy firm failure is viewed negatively and as representing a drain on society's resources. According to this view, resources should not be invested in higher risk ventures. When viewed through the lens of the entrepreneurial economy, firm failure is interpreted differently. It is seen as an experiment, an attempt to go in a new direction in an inherently risky environment. An externality of failure is learning. In the entrepreneurial economy, failure accompanies the process of searching for new ideas. It similarly follows that the positive virtues of long-term relationships, stability, continuity under the managed economy give way to flexibility, change, and turbulence in the entrepreneurial economy. What is a liability in the managed economy is, in some case, a virtue in the entrepreneurial economy.

The current policy debate has been erroneously miscast as more versus less government. The wave of government downsizing, combined with deregulation, privatisation, and the retreat of antitrust has created an impression that there is no more role for the government to play other than to get out of the way of private interests. What has been overlooked is the inherently different role of government policy in the entrepreneurial than in the managed economy. The Silicon Valleys, Research Triangles, Route 128s, and Austins of the world were not created in a vacuum. The policies helping to shape such innovative clusters are not only different in that they are local, rather than national, but they also target inputs in the process of creating and commercialising knowledge, rather than outputs, such as particular firms.

Government policy in the managed economy was largely about control. High certainty dictated that it was known what to produce, how it should be produced, and who would produce it. The role of government was to constrain the power of large corporations, which were needed for efficiency under mass-production, but posed a threat to democracy through their concentration of power. Under the managed economy the policy debate centred on competition policies (antitrust), regulation and public ownership of business. In the entrepreneurial economy these constraining policies have become increasingly irrelevant. The central role of government policy in the entrepreneurial economy is enabling in nature. The focus is to foster the production and commercialisation of knowledge. Rather than focus on limiting the freedom of firms to contract through antitrust, regulation and public ownership, government policy in the entrepreneurial economy targets education, increasing the skills and human capital of workers, and facilitating the mobility of workers and their ability to start new firms.

The economic failure of the Soviet Union and her Eastern European satellites was to a great extent a failure to participate in the micro-electronic revolution.⁵² Computerised technology implied a shift away from a concentrated and rigid structure and toward a fluid, decentralised system as the most efficient means of production, which constituted a direct threat to the political principle of centralising all information and decisionmaking under communism. While the demise of communism has been widely celebrated as a victory for western capitalism, what has been overlooked is that the system of capitalism dominating most of this century – the managed economy – is now itself under attack by the same forces that undermined communism.

The prevailing view about the gains to Europe through integration has been formulated in terms of lower costs resulting from a greater exploitation of scale economies. The 1988 *Cecchini Report*, building on the tradition of Servan Schreiber (1968), measured these gains to Europe in terms of cost reduction. Through growth, mergers, combinations and rationalisation, larger European firms will generate gains to European consumers in the form of lower costs. Convergence of institutions and nations in Europe is a goal, since this facilitates the single European markets and large-scale production and sales. Focusing on scale economies resulting from a large market size is a metric implicit in the managed economy. The analysis of this paper, focusing instead on the entrepreneurial economy, predicts *the major economic benefits of European Integration will come not through economies of scale, but rather through economies of diversity*. In an uncertain world, the diversity of European cultures and institutions is well positioned to generate a diversity of different approaches to economic problems. Diversity, not convergence, generates innovation and growth.

⁵²Sylos-Labini (1992, p. 63) observed that, “In the last two or three decades, after a number of attempts that ailed at decentralising many activities and of giving more discretionary power to managers, the difficulties rose very rapidly and the Soviet economy entered a period of general crisis. Concentrating economic, organisational, and scientific efforts on military production, the Soviet Union has succeeded, at least for a period, in not losing ground in this sector with respect to the United States and other Western countries. But even this sector -- after the latest developments in electronics, which, especially in the United States, owe much to the contribution of small firms -- has shown increasing signs of weakness.” See also Richard R. Nelson (1992).

A series of empirical studies has identified that a pervasive shift in the industrial structure away from large corporations and towards small enterprises has taken place between the mid-1970s and early 1990s.⁵³ This shift occurred not just in one or a few of the developed countries but rather in virtually every single leading industrial country. Is such a shift desirable and should the resulting industrial structure be promoted or avoided? Prevailing economic theory provides a set of ambiguous answers, which essentially depend upon a number of trade-offs between what is gained and lost by shifting economic activity towards smaller enterprises. While this ambiguity cannot be easily resolved, in this paper we have attempted to identify at least the most important of these trade-offs. The empirical evidence from linking growth rates to changes in the industrial structure suggests that the ongoing shift towards smaller enterprises tends to promote rather than retard economic growth. Those countries which have introduced a greater element of entrepreneurship have been rewarded with additional growth. It is now the task of policy makers also seeking to reward their economies with additional growth, to re-formulate policy in harmony with the shift from the managed to the entrepreneurial economy.

⁵³ See the country studies included in Acs and Audretsch (1993) and Loveman and Sengenberger (1991).

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