

## THE CONCEPT AND ROLE OF SMALL ENTERPRISE IN NATIONAL ECONOMY

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The article shows that there is no unanimous opinion in theory and practice on what a small enterprise is. This creates misunderstandings, ambiguity and controversies in legislation, as well as creates uncertainty with regard to the formation and functioning of the type and forms of state support. The author presents an analysis of the existing definitions and criteria of small enterprise. The author suggests to consider the criteria of quantitative certainty of small enterprises and analyzes the factors which determine (or not determine) whether small enterprises require state support from the perspective of tackling national economy problems.

**Key words:** small enterprise, small business, definition, quantitative indicators, normal profit, economic criteria

In economic, scientific and especially popular journalistic literature the requirement to support small business is presented as a matter of fact that does not need any special analysis or substantiation.

However, in real life in many countries, especially in those which have gone through or are currently still undergoing the transition to the market economy, there is an almost unanimous opinion that so far no effective forms to support small enterprises have been found.

Why this unanimity in such a principal issue has not materialized itself in practical measures?

This may be due to a number of theoretical factors. First, this is not absolutely clear what a small enterprise is. Second, the question why small enterprises require special state support is still open.

Therefore, in order to establish effective forms of support to small enterprises, it is necessary to elucidate several theoretical and practical aspects, the first being the definition of small enterprise.

Economic and legal literature does not provide a uniform approach with regard to this issue. This causes ambiguity, misunderstandings, and controversies in legislation and creates further uncertainty related with the formation and functioning of the types of state support to small business. There are several definitions of small enterprise in legal documents effective in the Republic of Latvia. These definitions are based on such quantitative criteria as assets value, net sales and average number of the employed.

The LR law "On the corporate income tax" defines a small enterprise by the following criteria:

- book value of fixed assets – 70000 Ls;
- net sales – 200000 Ls;
- average number of persons employed – 25.

The LR law "On corporate annual reports" provides for skipping several types of accounts and does not require submission of some documents to the Enterprise Register to companies meeting the following three criteria:

- value of balance total up to 0.15 mln ECU;
- annual net sales – up to 0.3 mln ECU;
- average number of persons employed – 25.

The Regulations "On the control of state and municipal support to business" classify small and medium-sized businesses as having up to 250 employees, and net sales of which do not exceed LVL 2 million or whose balance total does not exceed LVL 1 million.

The legislation effective in different countries specifies different criteria.

For example, according to the British legislation, the category of small businesses includes enterprises meeting two of the following criteria [1, p. 400]:

1. sales – up to J 2 mln.;
2. book value of assets – up to J 970000;
3. number of persons employed – up to 50.

The United States Small Business Administration highlights quantitative indicators – employment and production volume (sales) are differentiated by the branches of economy, i.e. services, industry, wholesale, retail, construction, agriculture. In addition to these there are also a number of qualitative criteria a small enterprise should comply with [2, p. 371]:

1. it must be independently owned and operated; and
2. it may not be dominant in its field.

The criteria for small business referred to above practically do not consider qualitative criteria. There are only quantitative criteria that are complicated to substantiate. We think that the criteria of 25 or 250 persons (why not 30 or 300?) employed are difficult to substantiate.

In essence, the criteria (definitions) specified in different legal acts refer to the specific law and should not be perceived as true definitions of a small enterprise.

It is necessary to develop a definition of a small

enterprise which would reflect the economic essence of this concept.

Quantitative indicators only should not form the basis for the classification of enterprises. Of course, they may have a specifying role in legal documents. At the same time, the classification analyzed has to be based on qualitative criteria derived from the specifics of the economic essence of the particular entity.

A rather widespread formulation of a small enterprise is given in the Boulton Parliamentary Committee Report (UK) "... a firm may be included in the category of small enterprises, if, first, it has a relatively small market share for the realization of its products".

Second, it is operated by its owners or partner-owners instead of via a formal management structure. Third, it is independent in a sense that it is not a part of any bigger enterprise and its owners, who are also operators, when they have to take principal decisions, should not submit to the control from the outside" [3, p. 6]. This formulation adds essential qualitative features which may form the basis of the classification analyzed. However, they must be complemented and specified.

Some authors try to differentiate between small, rather small and tiny or micro enterprises. For example, J. Reiters includes in the category of small enterprises sole proprietorships (family businesses), medium-size and small agricultural farms and fisheries which have a stable production cycle and can ensure means of subsistence to all the persons engaged in this activity for at least one year. A rather small business is a type of a business that has a stable production cycle and can provide means of subsistence to everyone engaged in this operation for a longer period of time. A tiny or micro enterprise is any of the enterprises referred to above on condition that its production cycle is not stable and performance results cannot ensure means of subsistence to all persons engaged in this operation [4, p. 22].

Recognizing the relevance of qualitative features outlined in the definition suggested by J. Reiters, however it should be concluded that these definitions do not provide the required certainty. For instance, a sole proprietorship can be very large, with more than several dozen employees etc., but according to the definition suggested, it meets the criteria of a small enterprise.

J.W. Carland, F. Hoy, W.R. Boulton, J.A.C. Carland try to differentiate between the concepts of small business and entrepreneurship, regarding that, despite the many common features, they are still different notions. A small business firm is operated by an independent owner, it is not dominant in its branch,

it does not expand and does not carry out innovation activity, at the same time the main goal of entrepreneurship is profit and growth [2, p. 372]. T.L. Wheelens and I.D. Hungers regard that the basic feature of a small enterprise is its attitude towards growth and innovations. A small enterprise does not grow and is not engaged in innovation activity [2, p. 372].

My opinion is that is not reasonable to separate small business from entrepreneurship. Both of them represent an entrepreneurial activity. The goal of entrepreneurship is to make profit. The concept of profit comes to the fore with an instant when product is manufactured for sale. It is commodity economy. There is also another type of business – natural economy when production in general or some particular product is manufactured for own consumption, i.e. to satisfy the needs of producers in this product. Thus, business activity can be split into natural economy and production of goods for sale.

In the commodity economy, depending on the goals of its operation, it is possible to differentiate between two types of enterprises. In the first case the incomes gained cover all production costs, including the so-called opportunity costs, i.e. remuneration to the entrepreneur for the work invested, capital etc. In the economic theory such income is called "normal profit". Normal profit is the minimum return to the owners of the firm which it needed to induce them to keep the firm going. [5, p. 214]

Receiving normal profit the enterprise can continuously renew its operation. The main goal of such an enterprise is satisfaction of the needs of the owner (his family). It is obvious that the enterprise which receives only normal profit is only reproducing itself. Its ability to make investments is limited. Thus, it is not expanded. So this type of enterprise may be called consumption enterprise.

Another type is represented by the enterprises receiving the so-called economic profit. Economic profit is profit which exceeds normal profit. Economic profit is the source for investment and development. Such enterprises can be called profit enterprises. Figure 1 presents a graphical scheme of this classification.

It is known that the main goal of operation of enterprise (satisfaction of the needs of the entrepreneur, or gaining economic profit and development) is an essential qualitative borderline. Consumption enterprises may be regarded as small enterprises. Such interpretation is reflected in the definitions formulated by a number of authors (J.W. Carland, F. Hoy, W.R. Boulton, J.A.C. Carland), i.e. they maintain the opinion that a small enterprise (business) is not growth-oriented, as well as the criterion suggested

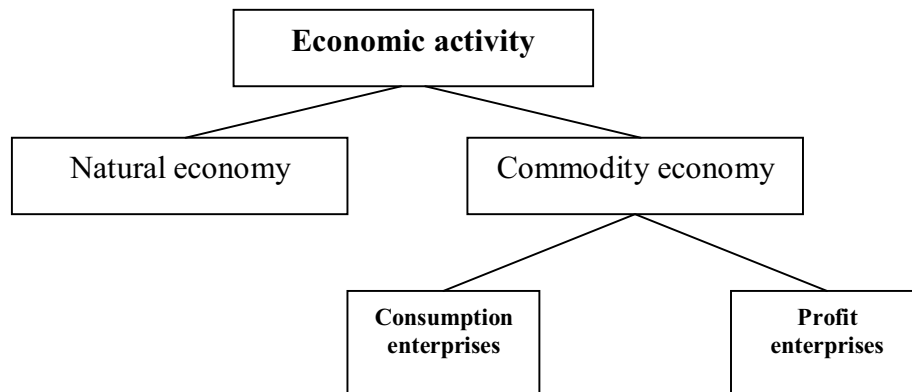


Fig. 1. Classification of economic activity

by J. Reiters on provision of means of subsistence for its employees.

Thus, in terms of its economic essence, **an enterprise may be classified as small if it earns only normal profit (according to the economic theory), it does not dominate in the branch, and it is operated by its owner.**

An even more important question is: why do small enterprises need special state support? The positive sides attributed to small enterprises may be subdivided into two groups. The first is based on the opinion that small businesses have certain advantages pertaining to this type of enterprises. The other group is related with aspects of national economy.

Let us analyze the arguments in favour of the first group. It is noted that small enterprises are more flexible in adapting to changes and are quicker to introduce innovations and respond to the changes in the consumer demand; their flexibility is their competitive advantage, etc. [3, p. 3]. These statements allow concluding that small enterprises have certain advantages in comparison with large enterprises. If so then the only task of the state is to ensure free competition, as a result of which these advantages will realize economically. The economic theory and practice has proved that under free competition it is not big or small business that operates successfully, but rather the effective one. In the conditions of the market economy (competition) there are branches with several (or even one) big enterprise as well as branches with thousands of small enterprises. The number of enterprises in the branch is determined not by the subjective will (decisions) of the government, business circles or the public but rather by the market.

For instance, if the optimal size (in terms of the effectiveness of production) of an enterprise in a branch is 250 thousand production units per year and the demand for these products is also 250 thousand production units per year, then only one enterprise

will function in the branch. At the same time, if the optimal size of enterprise is 10 thousand production units per year and the demand for these products is 250 thousand units per year, then 25 enterprises will function in this branch.

Thus, the number of enterprises is determined by the relation between the optimal size of the enterprise and the volume of the demand in the respective branch. At the same time, the optimal size of enterprises is determined also by the technologies used in the respective branch. Thus, if the size of enterprises operating in the branch is small (correspondent to the status of a small enterprise), then no special support to small enterprises is required. The task of the state is only to ensure possibilities of free competition. At the same time, if the state wants to especially support small enterprises in branches where large enterprises are optimal, then it has to be aware that such support is targeted at inefficient production, which may reduce the competitiveness of the branch and incur a number of other negative consequences in a longer term. State support to such small businesses requires special substantiation.

Speaking about small enterprises, it is noted that very frequently they are specialised in manufacturing separate units or parts, and big enterprises assemble these parts in final products. As a result, big firms thus substantially reduce their production costs using the highly specialized services provided by small enterprises [3, p. 7]. In many cases it is typically so. However, there is also another trend. Big firms frequently take advantage of the situation that small firms have only one contractor or supplier of raw materials. And it dictates the prices, terms of payment and other conditions, supplies raw materials at fixed prices etc. Thus it is a situation which was typical in the period between craftsmen's guilds and manufactures, which professor A. Kaufmanis has referred to as the big industrial household: "craftsmen ... worked in their own workshops and with their

own tools, but masters who bought up their products provided them with materials and paid remuneration to them for processing of these materials, keeping the profit share to themselves" [6, p. 60]. Such situation, only in a more contemporary form, can also be observed in Latvia. In the woodworking industry small enterprises usually do not export their products directly, but supply them to big exporters. And the latter then dictate their rules of the game to the small ones. Big food processors and traders often do the same with small producers and raw material suppliers. In such situations big enterprises keep small enterprises within the boundaries of normal profit. If such enterprises are granted state support in the form of subsidies, tax facilities, etc., then it will substantially improve the financial performance indicators of the big enterprises rather than the situation of the small firms.

The second group of advantages is related with national economy aspects, primarily with the improvement of the employment situation of the population. However, it must be remembered that enhancement of the employment rate at the expense of reduction of the effectiveness of production, especially in a situation when this effectiveness is rather low, in a long term may have negative implications. It should be remembered that low production effectiveness does not allow ensuring funds for any support. There is no doubt that there can also be situations when a low unemployment rate in a country or a particular region may provoke social tension and can cause political instability or social explosion. Thus small enterprises act as bumpers for economic fluctuations and as a stabilizing factor in the social and political area. So, it may be asserted that there are situations when short-term goals may be very relevant and essential.

The costs of creation of one new working place in a big enterprise equipped with up-to-date plant and machinery and technologies is much higher than in a small (less effective) enterprise. By developing small enterprises it is possible to attain a higher employment rate and a more rapid growth of GDP with smaller investment amounts. Therefore a low employment rate and the necessity to increase the economic growth rates in the conditions of limited investment funds call for the necessity to invest in small enterprises (i.e. to support them). However, it has to be understood that it does not mean a massive transfer to "small production", since in a long-term it may cause technical and technological backwardness. A negative example of such activities is the Chinese

"big jump" policy to family-owned metal casting and other enterprises. It is necessary to perform a thorough analysis and selection of branches where state support is to be granted to small enterprises that are capable of yielding the biggest effect, and in which case the detriment, in a long-term perspective, will be the smallest.

There may also be other economic, culturally historical, as well as political and social considerations when priority has to be given to tackling particular national economy related problems rather than to the effectiveness of production.

G.B. Kochetkov writes that small business in the US is the decisive form of business organisation through which millions of entrepreneurs implement their desires and contribute to the economic life with new ideas [7, p. 79].

In this situation the focus is on the enhancement of activity of population and reduction of social tension, as well as on the particular effect on the national economy.

Thus the conclusion to be made is not that it is necessary to support all small enterprises in general but that this support should contribute to the attainment of specific national, culturally historical and social goals. Based on these goals it is necessary to select both the objects for support as well as the most appropriate form. In a specific economic and social situation in a given region or branch these goals may be different, i.e. production of new types of products, necessity to retain a specific life style and specialisation of production, minimization of the sources of social tension, enhancement of competitiveness, etc.

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