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CESifo Forum

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Suggested Citation: Audretsch, David B. (2007) : From small business promotion to creating an entrepreneurial society, CESifo Forum, ISSN 2190-717X, ifo Institut für Wirtschaftsforschung an der Universität München, München, Vol. 08, Iss. 2, pp. 3-6

This Version is available at:
https://hdl.handle.net/10419/166291

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Small- and Medium-sized Enterprises

From small business promotion to creating an entrepreneurial society

David B. Audretsch*

Globalization and the European Paradox

When the Berlin Wall fell in November 1989, most scholars as well as policy makers anticipated a so-called peace dividend for Europe raising economic growth. After all, the post-war recovery of Europe, and especially of some countries such as Germany and Sweden, had been based on wresting the comparative advantage from the United States in key capital-based industries including automobiles, steel and machine tools. Economic growth, employment and competitiveness throughout the post-war era had been driven by physical capital. Just as Robert Solow (1956 and 1957) was awarded a Nobel Prize for identifying physical capital as the main factor driving economic growth, it was surely no coincidence that decades earlier Karl Marx had titled his history-changing book *Das Kapital*. Based on Europe's favorable export performance of capital-intensive products to the United States, its export dominance also appeared to be guaranteed in the markets of Central and Eastern Europe as well as in Asia, especially China.

Thus, it came as something of a shock when it became evident that, rather than reinforce the post-war European comparative advantage in capital-goods industries, the post-Berlin Wall globalization triggered a loss in European competitiveness in its stalwart traditional manufacturing industries. Driven by the harsh logic of globalization, European companies were increasingly choosing to outsource and offshore in a desperate effort to remain competitive (Friedman 2005). While this might have preserved, or even enhanced, the competitiveness of some European companies, it eroded the levels of economic growth throughout Europe and triggered increases in unemployment that ratcheted upwards throughout the decade of the 1990s.

An article entitled, "Germany: World Leading Exporter (of Jobs)," in the prestigious weekly German magazine, *Der Spiegel,* reports that employment in manufacturing rose throughout the era of the post-war managed economy, increasing from 12.5 million in 1970 to 14.1 million in 1991; then, as globalization hit Germany, manufacturing jobs crashed to 10.2 million in 2004.[1] Between 1991 and 2004, the number of jobs in the German textile industry fell by 65 percent, from 274,658 to 94,432. In the construction industry, there was a 58 percent decrease in employment in Germany, from 1.9 million jobs to 778,000. In the metalworking industries, employment decreased from 576,299 to 250,024, or 47.5 percent. And in the heart and soul of German manufacturing, the machine tool industry, the number of jobs fell from 1.6 million to 947,448, or 39.1 percent.

Both outsourcing and offshoring have emerged as a strategic response to global competition, helping businesses maintain and, sometimes, enhance profitability. In Germany, this phenomenon has brought on a seemingly schizophrenic euphoria. On the one hand, corporate executives and policy makers are celebrating a "champagne mood", as profits are rising to record levels, sales increasing, and the overall prospects for German corporations looking better than they have been in years.[2] On the other hand, unemployment remains perilously close to five million unemployed workers, as one of the influential daily German newspapers, *Die Welt,* warned Germany's chancellor, Angela Merkel, "what use is the new strength and optimism of German companies if nothing is changed in the labor market."[3]

Even as the comparative advantage in (physical) capital in Europe was beginning to fade, scholars and policy makers began to recognize the primacy of a very different production factor – knowledge capital,

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[1] Bye-Bye Made in Germany, *Der Spiegel* 44 (2004), 94.
[2] This is referred to as Sektstimmung (sparking wine mood), Angst vor Aufschwung ohne Jobs, *Süddeutsche Zeitung,* 1 February, 2006, 1.
[3] Merkel ist gewarnt, *Die Welt,* 1 February, 2006, 8.

which is based not just on technological and scientific knowledge but also in a broader sense of ideas, creativity, originality and novelty. The recognition by Romer (1986) and Lucas (1993) among others, that knowledge was not only endogenous but that it also spilled over for commercialization by firms and individuals other than the firm or university actually creating that knowledge in the first place, shifted the policy debate and focus away from instruments inducing investment in physical capital towards instruments generating knowledge and ideas, such as university research, education and training, and patents.

In particular, the Nordic countries, but also Northern Europe more generally, ranked among the world's leaders in terms of the most common measures of knowledge. Thus, the inability of countries which were knowledge leaders, such as Sweden, to prosper in the global economy was so striking that it was referred to as the Swedish Paradox. However, it was not just Sweden that exhibited surprisingly low growth rates and suffering from increasing unemployment, while at the same time having high rates of investment in research, human capital and culture. The European Union adapted the label to describe what it termed *the European Paradox*. While the prescriptions for investment in knowledge generated scholarly economic models, the experience of Sweden, and in fact much of Europe, was suggesting that the links between knowledge and growth are, in fact, more nuanced and complicated.

The knowledge filter

The conditions inherent in knowledge – high uncertainty, asymmetries and transaction costs – result in decision making hierarchies in companies arriving at the decision *not* to pursue and try to commercialize new ideas that economic agents think potentially valuable. The characteristics of knowledge distinguished from information, a high degree of uncertainty combined with non-trivial asymmetries, a broad spectrum of institutions, rules and regulations impose what Audretsch et al. (2006) and Acs et al. (2004) term *the knowledge filter.* More precisely, the knowledge filter is the gap between knowledge that has a potential commercial value and knowledge that is actually commercialized. The greater is the knowledge filter, the more pronounced is the gap between new knowledge and commercialized knowledge.

As already mentioned above, it is the knowledge filter that impedes investment in knowledge from spilling over into commercialization that leads to the so-called Swedish Paradox and European Paradox. Europe was not alone in having investment in knowledge choked off by the knowledge filter from resulting in economic growth. The United States has also not been able to avoid the knowledge filter. In fact, the knowledge filter impeding the commercialization of investment in research and knowledge can be formidable. As Senator Birch Bayh once warned, "a wealth of scientific talent at American colleges and universities – talent responsible for the development of numerous innovative scientific breakthroughs each year – is going to waste as a result of bureaucratic red tape and illogical government regulations …"[4] It is the knowledge filter that stands between investment in research on the one hand, and its commercialization through innovation, leading ultimately to economic growth, on the other. Seen through the eyes of Senator Bayh, the magnitude of the knowledge filter is daunting: "what sense does it make to spend billions of dollars each year on government-supported research and then prevent new developments from benefiting the American people because of dumb bureaucratic red tape?"[5]

Confronted with the knowledge filter impeding the spillover of knowledge from the firm or organization, where it was originally generated, into commercialization by third-party firms, the public policy instruments aimed at promoting investment in knowledge (such as human capital, R&D and university research) may not adequately stimulate economic growth. One interpretation of the European Paradox, where such investment in new knowledge has certainly been substantial and sustained, but vigorous growth and reduction of unemployment have remained elusive, is that the presence of such an imposing knowledge filter chokes off the commercialization of new knowledge investment, resulting in diminished innovative activity and ultimately stagnant growth.

Emergence of the entrepreneurial society

By choking off the spillover and commercialization of knowledge and new ideas, the knowledge filter at

[4] Introductory statement of Birch Bayh, September 13, 1978, cited from the Association of University Technology Managers Report (AUTM 2004, 5).
[5] Statement by Birch Bayh, April 13, 1980, on the approval of S. 414 (Bayh-Dole) by the U.S. Senate on a 91-4 vote, cited from AUTM (2004, 16).

the same time presents opportunities for individuals, or teams of individuals, who place a high valuation on the potential of that knowledge, to become entrepreneurs. If people are not able to pursue and implement their ideas and visions within the context of an incumbent firm or organization that appropriates the value of their ideas, they should start a new firm, that is, become entrepreneurs. The entrepreneurial startup reflects knowledge spillover entrepreneurship because the ideas serving as the basis for the startup were obtained, typically for little or no cost, from a different incumbent firm or organization. Thus, knowledge spillover entrepreneurship serves as a conduit for the spillover of new ideas created by an incumbent organization but left "uncommercialized".

The knowledge spillover theory of entrepreneurship (Audretsch 1995; Audretsch et al. 2006) suggests that contexts which are rich in knowledge will tend to generate more entrepreneurial opportunities. Fewer entrepreneurial opportunities will be generated in a context with a lower amount of investment in new ideas and knowledge. A consequence of globalization, which has shifted the comparative advantage of developed countries from physical capital to knowledge capital, is that entrepreneurial opportunities become more pervasive (Audretsch 2007).

With the 2000 Lisbon Proclamation, Romano Prodi, who was at the time serving as the President of the European Commission, committed Europe to becoming the entrepreneurship leader in the world in order to ensure prosperity and a high standard of living throughout the continent. In particular, Prodi proclaimed that the promotion of entrepreneurship was an important cornerstone of European economic growth policy: "our lacunae in the field of entrepreneurship need to be taken seriously because there is mounting evidence that the key to economic growth and productivity improvements lies in the entrepreneurial capacity of an economy." (Prodi 2002, 1).

Romano Prodi and the European Union were not alone in turning to entrepreneurship to provide the engine of economic growth. The entrepreneurial policy mandate mirrored similar efforts throughout the developed world. Public policy spanning a broad spectrum of national, regional and local contexts was turning to entrepreneurship to replace old jobs which were being lost to outsourcing and globalization, while at the same time trying to harness the potential of significant long-term investment in knowledge, such as universities, education and research institutions.

Only a few years earlier the policy debate focusing on growth and employment had looked to the macroeconomic instruments of fiscal and monetary policy on the one hand, and the size and scale economies yielded by the large corporation, on the other. After all, scholars such as Alfred Chandler (1977), Joseph Schumpeter (1942) and John Kenneth Galbraith (1967) had convinced a generation of policy makers that efficiency and growth lay in the domain of large corporations and that small business would simply fade away under the weight of its own inefficiency.

In distinguishing entrepreneurship policy from more traditional approaches to business, a shift has occurred away from the focus on the traditional triad of policy instruments essentially constraining the freedom of firms to contract – regulation, competition policy and public ownership of business. The policy approach of constraint was sensible as long as the major issue was to restrain the market power of large corporations. The fact that this policy approach towards business is less relevant in a global economy is reflected by the waves of deregulation and privatization throughout the OECD.

Instead, a new policy approach is emerging which focuses on facilitating the creation and commercialization of knowledge. Probably the greatest and most salient change in small business policy over the last fifteen years has been a shift from trying to preserve small businesses that are confronted with a cost disadvantage due to scale disadvantages towards promoting the startup and viability of existing and new small firms involved in the commercialization of knowledge, or knowledge-based entrepreneurship.

Entrepreneurship policy vs. traditional small business policy

Entrepreneurship policy is a relatively new phenomenon. An important distinction should be made between traditional small business policy and entrepreneurship policy. Small business policy typically refers to policies implemented by a ministry or government agency charged with the mandate to promote small business. The actual definition of a small

business varies considerably across countries, ranging from firms with fewer than 500 employees in some of the most developed countries such as the United States and Canada, to fewer than 250 employees in the European Union, and to 50 employees in many developing countries.

There are at least two important ways that distinguish entrepreneurship policy from small business policy. The first is the breadth of policy orientation and instruments. While small business policy focuses on the existing stock of small firms, entrepreneurship policy is more encompassing in that it includes potential entrepreneurs. This suggests that entrepreneurship policy is more focused on the process of change, regardless of the organizational unit, whereas small business policy is more static in nature and remains focused on the enterprise level. Entrepreneurship policy is also more sensitive to framework or contextual conditions that shape the decision-making process of entrepreneurs and potential entrepreneurs.

While small business policy is primarily concerned with one organizational level, the firm, entrepreneurship policy encompasses multiple units of organization and analysis. These range from the individual to the firm, and to the cluster or network, which might involve an industry or sectoral dimension, or a spatial dimension, such as a district, city, region, or even an entire country. Just as each of these levels is an important policy target, the interactions and linkages across these disparate levels are also important. In this sense, entrepreneurship policy tends to be more systemic than small business policy. However, it is important to emphasize that small business policy still remains at the core of entrepreneurship policy.

The second way in which entrepreneurship policy is distinguished from traditional small business policy is that virtually every country has a ministry or governmental agency charged with promoting the viability of the small business sector. These ministries and agencies have by now developed a well established arsenal of policy instruments to promote small business. However, no agencies exist to promote entrepreneurship. Part of the challenge of implementing entrepreneurship policy is this very fact, i.e. that no country has yet introduced an agency mandated with the charge of promoting entrepreneurship. Rather, aspects relevant to entrepreneurship policy can be found across a broad spectrum of ministries and agencies, ranging from education to trade and immigration. Thus, while small business has agencies and ministries that champion their issues, no analogous agency exists for entrepreneurship policy.

Not only are the instruments of entrepreneurship policy decidedly distinct from those traditionally used to promote business and small business in particular, but the locus of such enabling policies is also different. The instruments constraining the freedom of firms to contract – antitrust, regulation and public ownership – were generally controlled and used at the federal or national level. By contrast, the instruments of entrepreneurship policy are generally applied at the levels of a state or city or local community.

Entrepreneurship policy ranges across a broad spectrum of instruments, spanning taxes, immigration, education, as well as more direct instruments such as the provision of finance or training. If entrepreneurship policy can be viewed as the purposeful attempt to create an entrepreneurial economy, entire institutions that were the cornerstone of the Solow Economy are being challenged and reconfigured, at least throughout the OECD countries, to create the entrepreneurial economy.

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