

The Growth Gap:

A small enterprise phenomenon

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July 2002
San Salvador, El Salvador

Document financed by the Federal Republic of Germany through the
Federal Ministry of Economic Cooperation and Development (BMZ),
Project ANEP/GTZ, German Agency for Technical Cooperation (GTZ)

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Executive Summary

In El Salvador it was observed that while many micro enterprises seem to perform relatively well, slightly larger enterprises seem to show a relatively poorer economic performance: investment, turnover and the willingness to contract external services do not grow in line with a growing size of the enterprise. What was observed might be labelled a “growth gap”. The following study tries to find explanations for this phenomenon.

The study introduces different established enterprise growth theories, focussing on static and dynamic concepts and internal and external reasons for SME growth. Static approaches consider “locally oriented SMEs” whose development strategy is limited to a certain area and is therefore a limit to its size, “arrested development” where the owner-manager chooses to maintain the company size limited, the “life-style firm” which is just large enough to guarantee the owner-manager a quality of life, and the argument of formalisation as an obstacle to further business growth.

Dynamic approaches consider make use of the biological metaphor of the “life-cycle” wherein enterprises are born, grow, and decline. The corresponding growth phases can be labelled “Start-Up”, “Expansion”, “Maturity Stage” and “Diversification Stage”. Within these growth stages, it is said, there can occur “disengagement stages”. Analysing both approaches the study concludes that neither one can give a satisfactory explanation for the observed growth gap.

A different life-cycle model by STEINMETZ however gives a promising explanation, focussing on strategic management aspects. The first phase of „direct supervision“ is followed by the stages of „supervised supervision“, „indirect control“ and „divisional organisation“. Many correlations and observations found in El Salvador do match the predictions of the model. The growth gap seems to stem mainly from critical management conditions and conflictive internal relations that may lead to a serious growth slowdown or a crisis that may even threaten the further existence of the company. Problems related to the legal formalisation of the enterprise aggravate the difficulties.

Based on the analysis the recommendations of the study centre their attention on the educational sector, a shift in Business Development Services, the development of adequate instruments and a change in the concepts of SME support organisations.

1 The issue to be explained: Introduction

In its support to the local SME¹ sector and especially its programme to strengthen the market for Business Development Services ANEP/GTZ, a project jointly executed by the Asociación Nacional de la Empresa Privada (ANEP) of El Salvador and the German Agency for Technical Cooperation (GTZ) and financed by the governments of both countries, observed a peculiarity in the growth pattern of SMEs in this country: Contrary to what might be expected there seems to be no strict correlation between the size of the enterprise measured in terms of turnover or employment and its performance in terms of investment, turnover or the willingness to contract external services such as business consulting or training. Rather, what can be observed might be labelled a “growth gap”: while the smallest entities seem to perform rather well there is a segment of enterprises between the top level of micro-enterprises and the middle level of small enterprises that seems to show, on average, a rather poor performance in the different criteria mentioned above.

Up to now, the described “growth gap” can only be labelled as a working hypothesis based on some statistical evidence combined with qualitative observation by the mentioned project and local SME support organisations². The graphs shown are based on data collected within the scope of investigations made to identify the decision making behaviour of entrepreneurs in regard to investing and to contracting business development services³:

Further data collection and statistical work has to be done to get to a clearer description and demarcation of the “growth gap” in the Salvadorean case and to verify its existence in other countries.

The following document starts from the mentioned working hypothesis that the performance of SMEs differs between different segments within this sector and that there is no direct correlation between the size of the entity and its economic performance. It explores the relevant literature to find plausible explanations of the growth gap phenomenon.

2 First overview: A four-field matrix of explanatory approaches

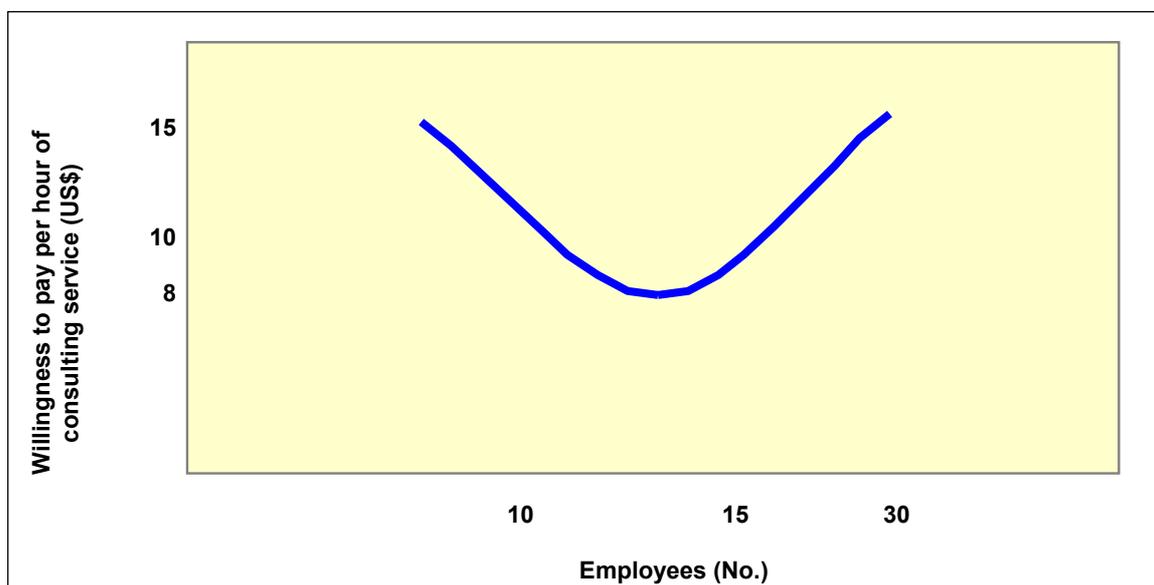
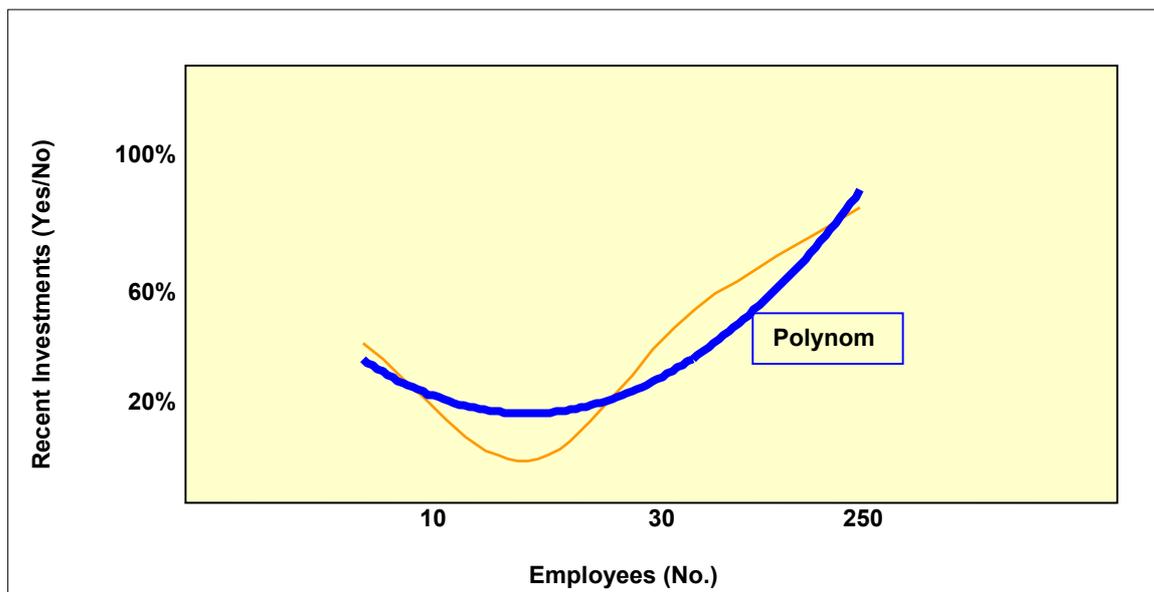
O’FARELL and HITCHENS (1988) classify available business growth theories into four main groups:

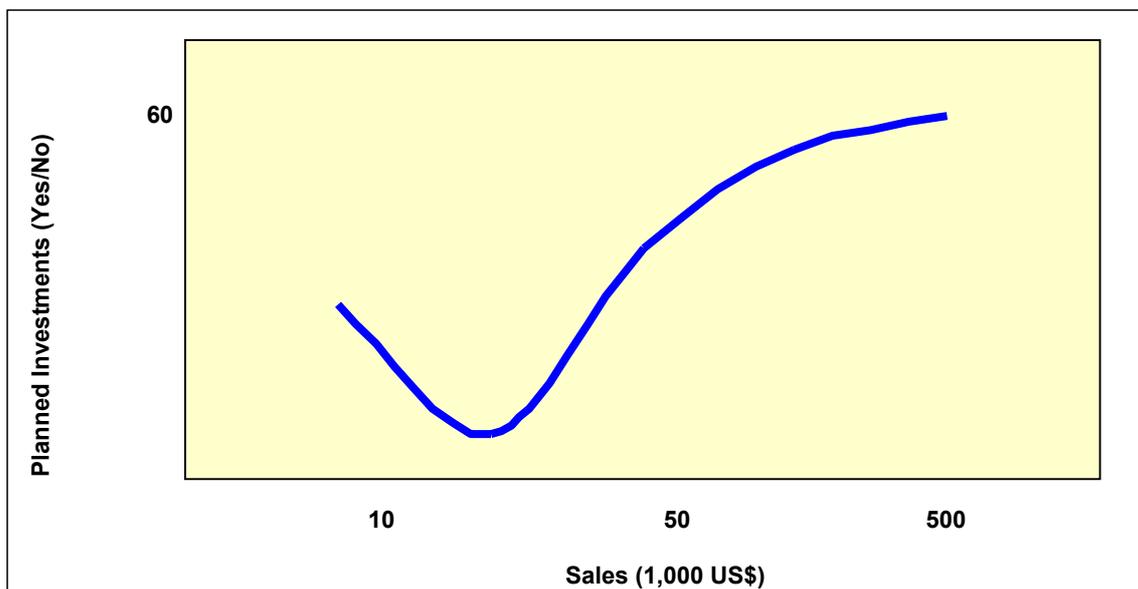
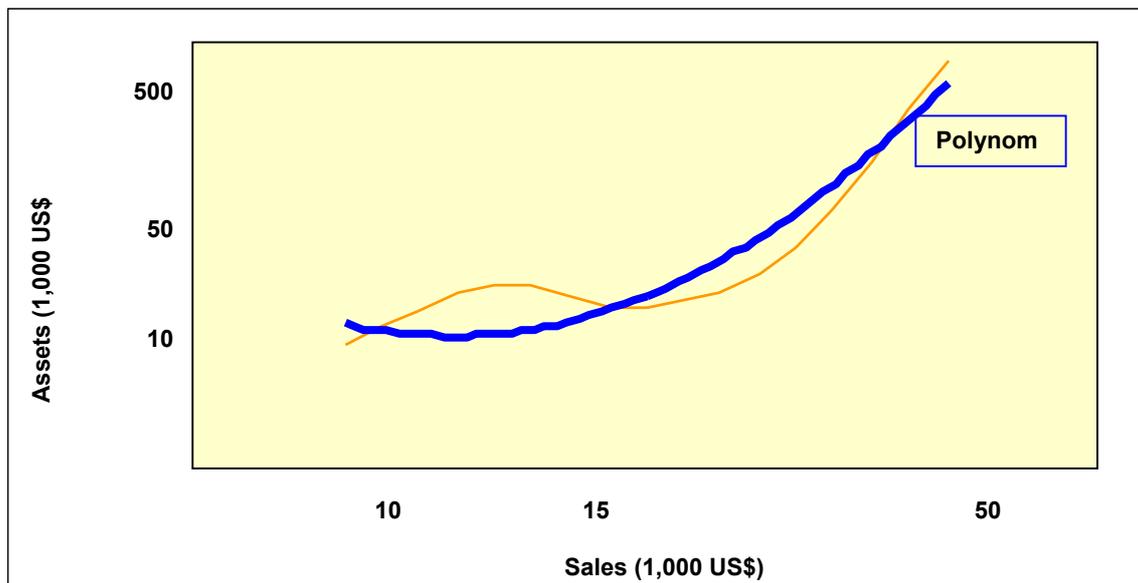
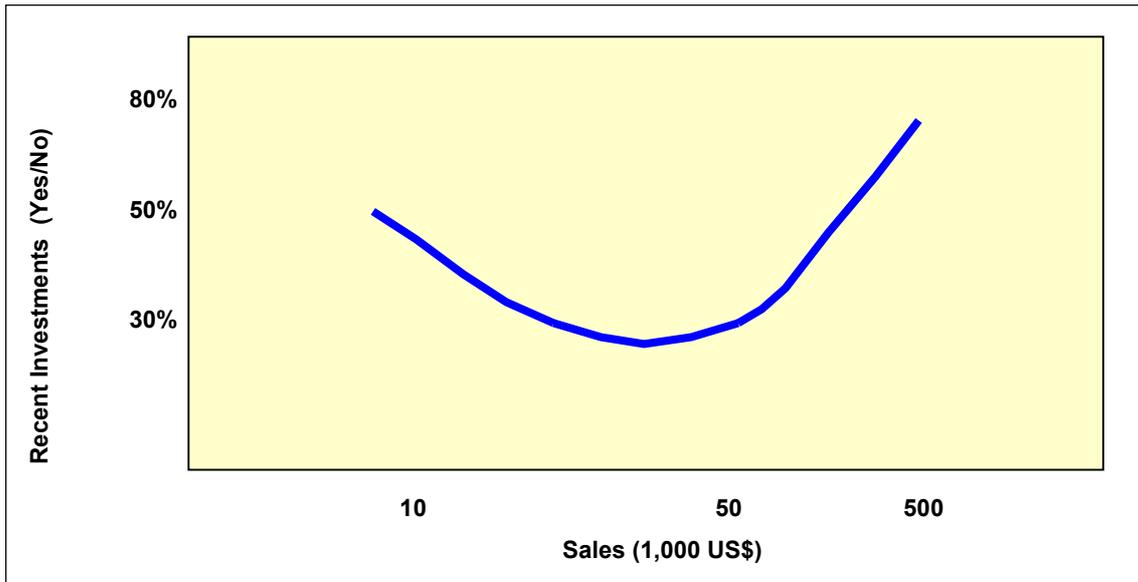
- Mostly static equilibrium theories derived from the field of industrial economics that are mainly concerned with attainment of economies of scale and minimisation of long-run unit costs;
- Stochastic models of firm growth which in summary suggest that “many factors affect growth” and that there is therefore no dominant theory (*ibid.*, p. 1370);

¹ SME stands for „Small and Medium Enterprises“ and includes for the purpose of this study also the micro-enterprises.

² The *National Commission for Micro- and Small-Enterprise Development (CONAMYPE)* observed e.g. an unusually high dropout rate at the margin between micro and small enterprises.

³ These graphs are largely based on research conducted by Lic. Francisco Orellana, FINECO and by ANEP/GTZ.





- Strategic management perspectives on SME growth which have “focused attention upon the strategic dimension of achieving sustained growth and the way in which the owner-manager responds to business and personal environmental indicators” (*ibid*, p. 1373);
- Theories according to which SME growth is viewed as a series of phases or stages of development through which the business may pass in an enterprise life-cycle.

For the purpose of this paper it seems promising to reduce the variety of approaches further and to distinguish on the one hand *static* from *dynamic* concepts and on the other hand approaches that search for *internal* from those that identify *external* reasons for SME growth (or non-growth). Combining those two distinctions we receive a four-field matrix of explanation approaches. *Table 1* gives a first overview of what this matrix will have to look like. The following parts of the document will be dedicated to develop the contents of the four central fields of the matrix.

Table 1: Approaches and criteria explaining SME growth and non-growth

	External criteria The company's environment	Internal criteria The look inside the company
1. Static approach:	Field 1.1	Field 1.2
There are different size levels and types of SMEs. There is no automatic “passing through” from level 1 to level 2 and further	There are <i>external</i> reasons that support or hamper the transformation from a “level 1”- to a “level 2”-type company.	There are internal reasons that may explain why a company remains on “level 1”, while the environment would permit the passing on to “level 2”.
2. Dynamic approach:	Field 2.1	Field 2.2
The growth of SMEs is compared to the development of living organisms: Over time the individual entity passes through different stages of the life-cycle	During its life-cycle the relationships between the company and its environment changes, thus in different moments the special setting in the environment may support or hamper growth.	During the growth process, the internal organisation and relations within the company change. The necessary adaptations affect the performance of the company in different stages of its life-cycle.

The contributions that will be discussed below have been developed in very different settings and for a variety of purposes, e.g. to scientifically back general support policies by governments, business advisory schemes (*Holmes / Zimmer 1994*) and start-up programmes or to be used to adequately train and prepare the small businessman him- or herself (*Steinmetz 1969*).

With few exceptions the concepts were developed based on experiences, observations or empirical studies in the industrialised world. However, as far as general conclusions are concerned, the main findings should as well be applicable to developing countries, considering that there are no plausible arguments to pretend that the main driving forces of SME growth should be different in countries with different levels of economic development. Of course, as we approach more specific observations and recommendations the relevant differences in the companies' environment have to be taken into account. Also, we find special situations and problems in developing countries that have no correlate in industrialised countries and have to be tackled with special concepts and approaches. The most important of these problems is the situation of informality in the micro and small enterprise segment.

3 Static approaches to explain the performance of SME

There are four important arguments that can explain why a small enterprise will remain small and not pursue a growth strategy, once a certain minimum size has been reached:

- the basic business strategy aims from the very beginning to capture a geographically clearly delimited market niche;
- the owner-manager values the disadvantages and risks of growth higher than the advantages and new opportunities;
- the owner-manager chooses voluntarily to keep his business small because of a limited achievement motivation or because of special personal reasons; and
- in the special case of developing countries a large part of small enterprises are informal: growth beyond a certain size requires formalisation that is often a complex and cost-intensive process.

We will now discuss those four arguments in detail:

3.1 The locally oriented SME

Many SMEs in the industrialised world as well as in emerging markets and developing countries pursue an explicit or implicit strategy that implies a clear limitation to growth. The typical case is an SME that offers standardised products and services on a local or regional market, e.g. SMEs in the retail or restaurant sector, bakeries as well as services like hair-cutting or car repair. In the great majority of these cases the business strategy chosen by the owner-manager of the SME was from the very beginning to occupy a local or regional market niche large enough to satisfy the own income expectations and to guarantee the maintenance or re-emplacment of buildings, machinery etc. Within this type of locally oriented SMEs and under given market structures there is a natural top to the business size. Growth beyond this level would mean a radical change in the basic strategy of the SME and the set of (explicit or implicit) objectives of its owner. It implies a fundamental re-organisation of the companies' structure in all areas (production, marketing, logistics). Generally spoken, further growth of an SME cannot be expected once the "optimum level" that corresponds to the specific local conditions has been reached. There are exceptions, however, that have to be considered as thus:

- In some cases locally oriented SMEs in traditional sectors have been transformed into large companies, most frequently by external growth, e.g. through the acquisition of similar SMEs in other local markets or through the establishment of franchising systems.
- When the basic market conditions suffer a rapid change SMEs may be confronted with the choice of "grow or die". A typical case for this "induced growth" is the German brewing industry: When the beer market was transformed from basically local relations to a national distribution system, many small breweries passed through a rapid growth process, often related with a change in the owner-structure or the acquisition by a large competitor.

We can resume that in industrialised as well as in developing countries we find a relevant segment of SMEs for which growth should not be expected. Their orientation on a stable company size is not contrary to the logic of a market economy but reflects a rationale strategy of locally oriented firms. They will invest, re-organise and contract advisory services whenever they consider this necessary or helpful for their goal of maintaining their market position.

3.2 “Arrested development”

Some empirical studies (*Hanks et al 1993, Davidsson 1989*) indicate that even firms that do *not* correspond to the above mentioned group of locally oriented SMEs may not grow, merely because the owner-manager *chooses* to maintain the company size limited (“arrested development”).

Empirical evidence (*e.g. Roper 1999*) shows that there is no direct link between small business’ growth and profitability. Once a viable scale of operation has been reached, there may even be a trade-off between further growth and the rate of return. With profit-maximisation being the driving force of decision making the owner or manager will decide in these cases to rather maintain business size small and profits high.

Business owners may also value the foreseeable disadvantages and risks of growth higher than the advantages and chances. This is in line with psychological observations that people tend to overvalue the potential of failure (*Plous 1993, p.98*), which translates in this context to failure associated with growth. They tend to be “risk averse” when gains are at stake (*Plous 1993, p.70*), thus avoiding investments required for the business growth when this affects the profits the company is still making.

3.3 The “life-style firm”

Once an SME has reached a size that permits the owner an attractive income there may arise a trade-off between his or her quality of life and further business growth. Expansion means permanently tackling new challenges, decision making and risk-taking. Therefore, it might be preferable for the owner-manager to maintain the business small and to play in an already known field. There has to be a strong intrinsic “achievement motivation”, a personal will to expand the business, make more money and lead an ever larger organisation (*e.g. Davidsson 1989*).

There are further reasons for maintaining the business small though the market and external conditions might be appropriate. Many business-owners do not want to share strategic decisions with business partners or even subordinates. They prefer the autonomy of being the leader of a small business to the advantages of being the general manager of a larger entity. This type of entity is labelled the “life-style firm” (*McMahon 2000, Hanks et al. 1993, Hay and Kamshad 1994*).

3.4 Informality and formality

In developing countries a large part of SMEs, especially informal micro-enterprises, is not growth-oriented: Frequently being established due to a lack of job-opportunities in the formal sector the main business goal is the reproduction of the entrepreneur and his or her family. In most cases the entity may grow up to the limits of available workforce within the family group and the market-limits set by informal sale channels. This aggravates the above mentioned low inclination towards risk-taking. Thus, besides the known critical external factors that hamper the growth prospects of micro-enterprises such as lack of access to training, credit and other business services (see below), there are also very relevant factors in the person of the micro entrepreneur and his or her business and growth objectives. As there is only a part of all enterprises interested to contract Business Development Services (*Schmitt-Degenhardt 2002*) one can safely assume that there will be a large proportion of micro-entrepreneurs who do not wish to grow with their business but who will prefer e.g. a formal job when they get access to it.

For this and other self induced and external reasons the growth potential of many informal SME is low.⁴

During the last decade a lively discussion has taken place about the real potential of the informal sector SMEs for future growth in developing countries. Mainly the work of DE SOTO (1989) and his followers has focussed the attention on the institutional environment of the informal SME that hampers or impedes their growth. The informal sector is seen as the victim of a deliberate discrimination by the local elite of politically influential big business. This elite hampers the bottom-up development of competitors by establishing high institutional barriers to the growth of SMEs. Due to their informality, poor people and small companies do not get access to licenses, credits, import permissions, foreign currency and fiscal incentives. DE SOTO stresses the discrimination of SMEs through complex, time-consuming and expensive procedures that impede the transition to the formal sector. Barriers to market entry through over-regulation are seen as the main factor to explain a low dynamic and the structural poverty within the informal sector. This implies that the deregulation of markets and clear property rights may be a very efficient means to unlock the growth potential of SMEs.

There are, however, strong arguments against this optimistic approach towards the growth potential of informal SMEs (e.g. *Altenburg 1996, p. 23*):

- Even if it can be considered a general problem of developing countries the bureaucratic barriers to the formalisation of a business and to the access of an SME to assets like credits or licenses differ largely between developing countries. During the last decade these barriers have been lowered through deregulation in many countries, however, no direct correlation can be found between the degree of regulation and the size of the informal sector.
- The disadvantages of informality described by DE SOTO may partially or completely be compensated for by a series of special advantages (e.g., no taxes) that the SME owner will lose once he or she formalises the business. A business owner who wants to expand his or her economic activities and has the means to do so may prefer to start further informal entities instead of growing and formalising the existing one.
- There are many additional reasons that hamper the growth of informal SMEs. Most of them work in branches with very low market entry barriers. Especially when the overall economic and employment situation is difficult, many people tend to start an informal business in one of those branches. Thus, competition is high. Growing beyond a once established market niche is very difficult and implies a radical change in behaviour and qualification. In this respect, the situation may be compared to that of the locally oriented SME in industrialised countries (see above).

4 Dynamic approaches to explain the performance of SMEs

Up to now we have discussed approaches that may explain why very small businesses may maintain their size and will not enter a growth path at all. It remains to be stressed that this non-growth orientation is in many cases in line with a clear and rationale entrepreneurial behaviour and the functioning of a market economy. The business owner acts in the best possible way to fulfil his or her explicit or implicit goals.

⁴ For a comprehensive overview over the differences between formal and informal SMEs see ALTENBURG 1996, p. 81

There is a second set of approaches highly relevant for the present document that are based on a dynamic view of the SME growth. Since the late sixties of the last century, a series of theoretical and empirical studies have been published that aim to explain the growth of SME making use of the biological metaphor of the “life-cycle”:

“Organizations are born, grow, and decline. Sometimes they reawaken, and sometimes they disappear” (Kimberley & Miles, cited by McMahon 1998).

4.1 Life-cycle models

Life-cycle models present a series of generally three to four stages through which an SME will typically pass throughout its development. They generally describe the dynamic within this growth process as “S-shaped”: a slow growth in the early development is followed by a rapid growth, before the dynamic tends to slow down again:

- In the first phase the business is set up, products are developed and first experiences are made on the marketplace. It is usually marked by relatively low growth rates. This phase is typically labelled “Start-Up” (e.g. Hanks et al 1993) or “Formation Phase” (Dodge / Robbins 1992).
- When the small business manages to pass successfully through this early stage it may enter the “Expansion” or “Early Growth Stage”. This phase is generally characterised by a rapid expansion of production, turnover and employment.
- After some time the development reaches a point where the initial business idea and concept will no longer guarantee a further dynamic expansion. Growth rates will decline, the company enters in the “Later Growth” (Dodge / Robbins 1992) or “Maturity Stage” (Hanks et al 1993).
- The future lies in a more defensive role of maintaining the conquered market position (“Stability”, DODGE / ROBBINS 1992) or, alternatively, in the advancement towards a broader business concept within which each new line of products or services may again pass through the described S-shaped growth process (“Diversification Stage”, HANKS et al 1993).

Life-cycle models can give very plausible descriptions of the typical growth of an SME or a business company in more general terms.⁵ What they cannot provide are explanations of *exceptions* from this S-shaped growth cycle. Why does the growth of SMEs in one or various phases of their life-cycle atypically slow down? Why do crisis occur in points on the growth curve where a rather strong dynamic could be expected?

One interesting approach is provided by HANKS et al. (1993) and was already explained above: There can be **disengagement stages** during the growth process (cf. “arrested development” and “life-style firms”). Firms in this stage are generally slightly larger than start-ups. In most cases the owners have consciously chosen to maintain their company small.

DAVIDSSON (1989) found in a study of Swedish firms that for many small business managers the negative effects of growth appeared to outweigh the positive outcomes once the firm had reached the size of five to nine employees. HAY and KAMSHAD (1994) found in their study on SMEs in the UK also a relevant (although not very large) group of disengaged entrepreneurs. Within this group they distinguish between “life-stylers” and “controllers”. While the first subgroup maintains the business small because they are not

⁵ The popularity of life-cycle models in SME or general business studies may be grounded in the fact that they provide an easily accessible heuristic framework both for the explanation of SME growth (and failure) and for the development of support measures. However, also serious doubts have been pronounced on the usefulness of life-cycle models in explaining business growth. O’FARRELL and HITCHENS (1988) present a comprehensive critique of stage models of SME development.adequate

willing to sacrifice profitability to sales growth or for personal reasons, the controllers are mainly interested in not having to share decision-making.

The second disengagement stage occurs after the expansion stage and is labelled “capped growth”. It is again the case of a deliberate abandonment of the growth path. CHURCHILL & LEWIS (*cited by McMahon 1998, n.p.*) explain this phenomenon as follows:

“the company has attained true economic health, has sufficient size and product-market penetration to ensure economic success, and earns average or above-average profits. The company can stay at this stage indefinitely, provided environmental change does not destroy its market niche or ineffective management reduce its competitive abilities”.

HANKS et al (1993) found the typical life-style firm having a mean number of 7 employees, annual sales revenues of US-\$ 0.41 million and a mean age of 18.71 years. The “capped growth” firm employs a mean of 24.65 persons, has annual sales revenues of about US-\$ 2.05 million and is in the average 12.65 years old.

4.2 Voluntary disengagement: Relevant to developing countries?

Voluntary disengagement in a very early (“life-style firm”) or a later (“capped growth”) stage of business development give a plausible and empirically tested explanation why firms that might grow, regarding their products, markets and so on, actually do not grow beyond a certain size. What remains to be discussed for the purpose of the present paper is the applicability of the concepts that are based on experiences in the industrialised world to developing countries.

Implicit to the two concepts are two presumptions:

- The business environment is rather stable and the future foreseeable in general terms.
- The competition in the special market segment is limited and poses no threat to the survival of the firm and the size of its operations.

Only under such conditions it seems a rationale business strategy to focus on what has been reached instead of permanently struggling to conquer new market segments, with the intention to expand operations when possible or at least maintain business size while loosing parts of the traditional market to competitors.

Under the development model of “industrialisation by means of import substitution” pursued by many developing countries in the second half of the 20th century this situation of overall stability was largely given. For the enterprises supplying the domestic market there was neither an incentive nor a need to pursue a growth strategy. Narrow markets put a clear top on the output level. On the other hand, state protection guaranteed the owners of firms sufficient income to maintain the life-style of an entrepreneur without the need to be one. Nearly all developing countries discontinued this development strategy during the eighties or nineties. The opening up of the national market led to a rapid increase of international competition in many sector traditionally served by SME (footwear, processed food, etc.). These changes in the market structure were generally accompanied by high fluctuations in the overall economic dynamic, with phases of rapid growth and recessions alternating over the years. Under these conditions neither the “life-style firm” nor the “capped growth” seem to be viable business models for the great majority of SMEs. So we should disregard the concepts of voluntary non-growth of SMEs⁶ as a relevant explication for the observed “growth gap”.

⁶ Here we have to make the exception of the locally-oriented (informal) SME that deliberately chooses to stay small once the break even points is reached and sufficient income generated.

5 Approaches to explain the growth gap in El Salvador

So far we discussed approaches to SME growth linked to industrialised countries and that apparently can only partly explain the growth gap observed in El Salvador. They however help to focus the discussion and to understand the underlying theories. We will now look at an interesting analysis based on one of the explained theories that can be transferred to the situation in a developing country.

5.1 Crisis and growth slowdown: Factors inherent to the life cycle of an SME

Some life-cycle models of business development identify points on the growth curve where the risk of a crisis or at least a serious slowdown in growth is high. STEINMETZ as early as 1969 looked for "Critical Stages of Small Business Growth" and based his analysis on a four stages life-cycle. While most life-cycle models see business development from an outcome perspective (growth rates, market position), STEINMETZ focusses on strategic management aspects. The first phase of „direct supervision“ is followed by the stage of „supervised supervision“, „indirect control“ and „divisional organisation“.

For the purpose of the present document it seems of special interest to see what STEINMETZ observes happening between the first and the second stage in the life-cycle. The phase of the "direct supervision" based on experiences in the US in the sixties comprises the very start-up phase until the business employs about 25-30 persons. During this phase the firm is propelled by the basic product idea and the efforts of the founder(s) to transform this idea into a viable business. With regard to decision taking and basic administration the enterprise remains largely a "one-person-operation". Relationships to the few employees are based on mainly informal interactions and personal acquaintance.

The first critical phase of business development in the life-cycle model of STEINMETZ seems to highly correspond to the "growth gap" observed by the GTZ in El Salvador, although the operation size with regard to employment is quite different. It occurs when the SME outgrows the "direct supervision" stage and passes to the "indirect supervision" stage. This requires fundamental changes in the attitude, behaviour and self-perception of the founder or owner of the SME. The qualifications needed for the successful mastering of the day to day work, responding to competition and growing clients expectations change fundamentally.

With increasing level of operations a large number of problems develop. Paperwork multiplies, personnel must be added on the payroll, facilities get crowded. In essence, the organisation becomes too large to permit the owner-manager to attend all relevant aspects personally. This implies that the SME reaches a point where a general transformation in the type of its management will be indispensable. The owner-manager has to delegate strategic functions to his employees. This requires a high grade of confidence between the owner and the second level of management.

Unacquainted with this kind of ceding of control the owner may decide to delegate important functions to relatives or other persons of his absolute confidence. These may, however, not always be the people best prepared for the needed jobs in intermediate management.

In other cases the owner or founder will have to learn how to rely on people outside of his inner personal circle. This implies a difficult learning process on both sides and may easily lead to a first slowdown in SME growth or even a serious crisis in its development. The owner has to learn how to delegate essential functions and limit his day to day actions to the supervision of the intermediate management. The intermediate management on the other hand has to learn how to take decisions corresponding to its

position in the company in a responsible manner and to the benefit of the firm as a whole.

Failing in this learning process may have serious consequences for the SME. The lack of flexibility in the thinking of the manager is seen as a serious threat for the company at this stage of its development.

“With inadequate supervision, some of his employees become disloyal and begin to resent the hard-driving attitude of the owner, thus creating motivational problems.” (Steinmetz 1969, p.32)

The transition from the owner of an entrepreneurship to the manager of a formal SME is not only one of attitude but implies a whole set of changes in the day to day work. Investment decisions have to be made in a formalised way and its financing has to be put on a solid base and be closely monitored:

“as a growing SME progresses through various life-cycle stages, the financial dimensions of its operations tend to become more problematic; and [that] there is consequently a greater need for careful attention to financial management if the growing concern is to succeed in survival and performance terms” (McMahon 1999, p.2).

Also production, sales and especially costs have to be monitored in a much stricter way than before to avoid a rapid decrease of overall productivity and profitability due to growing overhead costs, which are not necessarily made up for by economies of scale.

So, as the complexity of business operations increases a lot of qualifications are needed that neither the owner of the start-up nor persons from his inner circle may have. There has to be a process of staff selection and a subsequent process of integrating “outsiders” into an up to that point quite closed organisation.

STEINMETZ’ results were based on an analysis done in the US where enterprises act under generally very positive circumstances:

- the small entrepreneur could rely on a broad base of well qualified personnel for the intermediate management function;
- the dominant culture in the US was and is highly positive with regard to entrepreneurship and achievement motivation within the business sector;
- a well defined and strong legal system guaranteed the rights of all parties involved.

When these problems even occur in an entrepreneurial environment such as the U.S. it can be concluded that they should be more severe in countries with a less favourable entrepreneurial climate: Problems related to the recruitment of new personnel and especially aspects of trust and loyalty between the owner and the second level of management will be more acute when it is much more difficult to hire qualified people for the intermediate management functions and when the dominant view on entrepreneurship is less positive than in the US. This refers to many developing countries with an underdeveloped higher training system and with social and cultural traditions highly influenced by class conflicts – as a reality or as the dominant paradigm to explain stagnation or backlash in social development.

This transition from a largely informal start-up or micro-business to a formalised SME must in some way be seen as a “point of no return”. Once entered into the second stage of growth, the owner or general manager has to provide for a sufficient cash-flow to get the growing number of employees paid timely. Formalised financing of investment through banking implies regular debt-payments that have to be guaranteed by the regular cash-flow. In the formalised SME the process of recruitment and dismissal of personnel is much more complicated than in the smaller units. Thus, while the informal SME might respond to adverse external conditions by simple and transitory “downsizing” of its activity, the formalised company cannot do so.

5.2 The case of El Salvador

STEINMETZ' life-cycle theory can be supported (though not statistically proven) in great parts by observations made in El Salvador.⁷ The phase of the "direct supervision" corresponds to an observation that the predominant leadership style in micro and small enterprises must be characterised as "traditional": It is based on direct supervision and a one-person-operation. The entrepreneurs of those enterprises believe that individual decisions are better than group decisions and they usually mistrust outsiders⁸.

The change required to advance to the phase of "indirect supervision" is frequently difficult to achieve in El Salvador because particularly entrepreneurs of small enterprises (as well as employees) are rather resistant to change. As expected, they are also generally less educated and less visionary than owner-managers of larger enterprises. This rather hints to elements of an "arrested development" or a "life-style firm". The environment however provides also obstacles since indirect supervision requires well trained personnel that is difficult to find and relatively comparatively in El Salvador.

In El Salvador there is a lower general and technical level of education as in the USA, a higher conflictivity of the production factor labour leading to mistrust and requiring more intense supervision, and a less stable environment. There is furthermore a tendency to produce more capital intensive than economic theory for this country would suggest, leading to relatively smaller firm-sizes measured in employees. These might be explanations why the critical phase between the first and second phase of STEINMETZ' model seems to be at a lower level in El Salvador (between 8 and 15 employees as the illustrations in the introduction demonstrate) than in the USA.

The mentioned conflictivity of the factor labour deserves additional attention: Enterprises frequently consist of an inner circle of up to 5 family members and an outer circle of outsiders. While there is full trust between the members of the inner circle there is mistrust between both circles, which is growing with an increase in the number of outsiders. The conflictivity is primarily based on an autocratic management style and an inadequate organisational culture, and on both sides, employer and employee, on low educational standards, a rather exploitative behaviour and few shared values. Employees are frequently resistant to change, they feel a high job insecurity and are consequently disloyal to the company.

Regulations are putting another obstacle to the development of these enterprises. By law enterprises from 5 employees (including the owner-manager) onwards have to get formalised. In practice the enforcement starts only at some 10 or more employees, which is in the range of the discovered growth gap.

Many entrepreneurs in El Salvador apparently do not overcome this gap. On the one hand, there is a significant dying of enterprises at the stage of larger micro enterprises (8 to 10 employees). Adverse external conditions or conflicts in the organisation itself might easily put into question the further existence of the entity. This explains why formal small-scale enterprises may have this much higher death-rate. On the other hand, there seems to be a small peak in the age of the owner-manager and in the age of the enterprise in relation to the size of the enterprise measured in employees, indicating a non-advancement in enterprise-growth.

⁷ Unless otherwise mentioned the following data and observations are taken from BOHNSTEDT et al. 2002 and SCHMITT-DEGENHARDT 2002.

⁸ Expressed among others in their lower willingness to contract outside services.

5.3 Conclusions: A provisional explanation of the growth gap in SME development

Life-cycle models of SME growth provide us with a heuristic framework for the understanding of small enterprise development. They also allow to identify critical stages of growth when a crisis or at least a severe slowdown in growth rates is likely to appear. For the purpose of this document, the transition from a very small unit, managed in a highly informal manner, to a formal organisation that needs professional management is of fundamental importance. A series of factors may lead to a crisis during this transition period.

At which point on the growth curve this transition will take place seems to be a topic for further research. We have seen that some studies consider an entity of up to 25-30 employees as belonging to the group of “directly supervised companies”. In El Salvador the critical size of an SME (control span) seems to be much smaller (8-15 employees). It is plausible that the moment when the small business owner has to switch management practices from a highly informal and flexible “direct supervision” to a professional management of “supervised supervision” depends on a series of internal and external factors, such as:

- the experiences and management capacities of the owner-manager;
- the general and technical educational level of employees and employer;
- the branch in which the SME operates and the complexity of its operations. Thus, direct supervision is easier and possible to a larger scale in a firm that produces standardised and scale-intensive goods than in an entity with several product lines or more complex production and marketing processes;
- the traditional relationship between employers and employees, the organisational culture and the predominant values with regard to work and duty. When the risk of non-fulfilment of duties or even negative behaviour by the employees is high the limits to a direct supervision management are narrow;
- the legal and regulatory framework. When the rules of the game are clear and transparent, the management of an SME by direct supervision will be much easier than under poorly defined and changing framework conditions.

As a provisional explanation of the growth gap in SME development we may resume that at a specific point on the growth curve a series of entrepreneurial problems arise that are mainly related to management and internal relations and that may lead to a serious growth slowdown or a crisis that may even threaten the further existence of the company. In the case of El Salvador as in many other developing countries this bundle of problems is aggravated through the difficulties related to the transition from an informal entity to a formal enterprise and the associated regulatory procedures.

6 Recommendations

We have resumed some arguments from the SME-literature that help to understand why there is not necessarily a linear relation between the company size and the observed economic performance of SMEs and especially why small enterprises might perform poorer than many micro-enterprises. The main arguments were taken from literature based on empirical studies in industrialised countries and partly supported by observations made in El Salvador. It seems plausible that many arguments are highly relevant for developing countries with perhaps the exception of voluntary non-growth for

life-style purposes. Many aspects seem to be of higher relevance given the adverse business environment in many developing countries. Further studies should work more precisely on the interrelation between the *internal* factors of business slow-down and crisis and the *external* factors on the meso- (institutional support, e.g. training programmes), macro- (growth oriented economic policy) and the meta-level (overall attitude towards entrepreneurship, conflictive or collaborative relations between employer and employees).

Some preliminary conclusions for the future work of the development co-operation may be drawn from the main findings of the literature consulted for this document:

- Programmes of business-promotion should clearly distinguish between “growers” and “non-growers” within the SME sector. This is not in the first run a matter of mere business size. Micro-enterprises with not-standardised products or services and led by an entrepreneur with high achievement motivation may soon find themselves within the “rapid growth”-stage of the business life-cycle. On the other hand: a small or medium enterprises pursuing a locally oriented business strategy may not be a relevant growth candidate at all.
- MSME support organisations should acknowledge the fact that many –perhaps even the majority- micro and small enterprises do consciously or non-consciously not peruse a growth strategy for their enterprise. Some of the special incentives and subsidies to get them developed and growing might have to be very high to overcome this resistance, which results in a sub-optimal use of scarce resources. More investigation is needed.
- A methodology should be developed to identify and foresee –for the special conditions of developing countries- stages of SME growth where the risks of business slowdown or crisis are most relevant. This methodology should include a series of indicators that may help to easily detect situations of crisis in its early stages.
- Special “instruments for business restructuring and strategic re-orientation” have to be developed to help SMEs to prevent and overcome the growth gap. These instruments have to be based on the analysis of the factors responsible for this adverse situation and are a challenge for programmes aiming at the creation of an adequate environment of Business Development Services. Consulting attention has to be geared towards organisational development and coaching issues. This requires special skills, particularly soft skills on consulting methodologies and techniques. In El Salvador there are however only few service providers specialised on MSME consultings and on those skills. In case of a failure of an early stage detection of such crisis it should be considered however that a company passing through a serious crisis is not necessarily a promising candidate for private service providers due to its potential incapacity to pay for the provided services. Another study of ANEP/GTZ suggests market conform instruments for this situation (*Schmitt-Degenhardt 2002*).
- Governments should revise their formalisation policies with the aim to set strict requirements before or after the growth gap but not as additional burden when the enterprise is trapped in the growth gap.

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8 Acknowledgements:

Special thanks shall be given to Lic. Francisco Orellana of FINECO, El Salvador, for his strong commitment to this topic. Within the framework of other studies he conducted for ANEP/GTZ he researched beyond their respective scope and discovered and analysed some of the correlations described in this publication. The result of subsequent discussions with him influenced the outcome of this work.

Special thanks shall also be given to the team of ANEP/GTZ, Carolina Herrera, Juan Ramon López, Maritza Majano Rivas and Héctor Rodríguez for their relentless feedbacks, ideas and support.