

»» Friedman beats Schumpeter – stability, not crisis, fosters dynamic small and medium-sized entrepreneurship

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Authors: Wiebke Bartz, OECD

Prof. Dr Adalbert Winkler, Frankfurt School of Finance & Management, phone: +49 69 154008-776

Dr Michael Schwartz, phone: +49 69 7431-8695, research@kfw.de

In times of economic stability, dynamic and creative entrepreneurship is a central pillar of a society's growth and prosperity. But in times of crisis?

Are dynamic enterprises more likely to suffer losses and should economic policy then actively intervene to strengthen and stabilise entrepreneurship? Or should crises rather be understood as a creative act that rewards dynamic entrepreneurs with growth surges, favours structural change and, in this way, secures prosperity in the long term?

Two well-known economists represent the two opposing sides of this core question: Milton Friedman and Joseph Schumpeter. Which one of them is right? For German SMEs caught up in the 2009 financial crisis, at least, an analysis based on the KfW SME Panel supports Friedman's view – creative entrepreneurship benefits from stability.¹

Schumpeter: crisis is an act of creative destruction

Crisis can be understood as a particularly intense form of the process of creative destruction – at least in the understanding of Joseph Schumpeter. His view is that in a crisis – after a prolonged phase of stability – new innovative enterprises enter the market in huge numbers, successfully challenging many of the large enterprises that have existed for a long time. The crisis itself, however, remains a creative act. For this reason, economic policy must not fight against it, as it would otherwise jeopardise future prosperity and growth.

Advocates of this view regard rescue packages and central bank interventions aimed at containing a financial crisis as undesirable interferences in the market economy. They argue that even if economic policy stabilised the system, it would still hamper the process of creative destruction. That would result in a prolonged period of weak growth and productivity because it would grant unjustified competitive advantages to old, static and large enterprises over the new, small and dynamic enterprises.

¹ This paper is based on Bartz, W. and A. Winkler (2015), Flexible or fragile? The growth performance of small and young businesses during the global financial crisis – Evidence from Germany, *Journal of Business Venturing*. A modified version of this introductory contribution was also published recently at www.oekonomenstimme.org.

Friedman: entrepreneurship needs stability

It is known that Western governments and central banks did not follow Schumpeter's recommendations. The reason was that they did not situate the cause of the crisis in a process of creative destruction initiated by new, small enterprises but in distortions of the financial system itself. If left to themselves, however, these distortions hamper entrepreneurial activity and, hence, the process of creative destruction. Crisis is therefore not an expression of entrepreneurial activity but undermines its economic foundations.

Essentially, there are two reasons for this. First, a financial crisis generates a degree of uncertainty that makes the detection of profitable investment opportunities – the core mission of entrepreneurs – a gamble. Accordingly, fewer people are willing to take entrepreneurial action. Second, a financial crisis makes credit scarce and even enterprises that want to be active under these difficult conditions no longer obtain access to capital. This perspective – Milton Friedman's – regards combating financial crises as the supreme economic-policy dictate, which not only prevents unemployment, depression and deflation. In fact, combating crisis is deemed to keep the process of creative destruction going, which generates growth, innovation and productivity. It was not least for this reason that Friedman advocated a monetary policy that should do everything possible to secure price stability – with the aim of strengthening entrepreneurship and, hence, innovation and growth. Western central banks have elevated this view to the guiding principle of their action.¹

The process of creative destruction – in times of normality and crisis

As controversial as the two perspectives are in diagnosing crisis, they are very much in agreement that a process of creative destruction does occur in times of stability. This commonality was the starting point of an analysis of the relative growth successes of German SMEs in normal years and in the crisis year 2009 that was conducted in the context of a research project undertaken by KfW Research and the Frankfurt School of Finance & Management.²

Friedman and Schumpeter both suggest that enterprises identified as dynamic achieve higher growth rates in times of normality. If Schumpeter is right, these dynamic enterprises should receive an additional growth boost precisely in times

of crisis. Friedman's view, however, suggests that in times of crisis it is particularly the dynamic enterprises that perform comparatively poorly. These hypotheses were put to the test on the basis of the KfW SME Panel.³

What is creative entrepreneurship?

The main challenge for the empirical verification of the Schumpeter-Friedman controversy consists in identifying creative entrepreneurship as such. Six different criteria were applied:

Small and medium-sized enterprises are often regarded as prototypes of dynamic entrepreneurship because their size and age do not allow them to be included among the long-established enterprises that cling to the status quo.⁴ However, as the exclusive focus on enterprises' size and age can be quite problematic methodologically,⁵ further characteristics are examined that identify an enterprise as more or less 'entrepreneurial' in the Schumpeterian sense. These include market orientation, i.e. whether the enterprise also serves markets outside its home region, as well as its ownership structure, e.g. whether the enterprise is directed by managers who are also their owners, as is often typical of German SMEs. Sole traders and businesses founded by employees who lost their jobs, in contrast, are deemed comparatively less entrepreneurial.⁶

Conclusion: crisis hinders creative entrepreneurship

In normal times, enterprises with entrepreneurial characteristics have a growth lead. That was to be expected, as was the finding that crisis leads to a considerable growth slowdown.

But who is right, Friedman or Schumpeter? The analysis clearly corroborates Friedman's perspective, while it lends little support to Schumpeter's view. In other words, if the process of creative destruction also takes place in normal times, in times of crisis those creative enterprises that typically drive this process tend to have growth disadvantages compared with their competitors.

Friedman vs. Schumpeter 4:1

Specifically, the analysis reveals that of those enterprises that were identified as comparatively entrepreneurial, in times of crisis only small businesses retain their relative growth lead.⁷ Conversely, whereas young enterprises, enterprises that manufacture goods for markets beyond their regional market and owner-managed businesses had a growth lead in normal times, their growth suffered in the year 2009. Sole

traders, who are also regarded as comparatively non-dynamic and grow at a below-average rate in normal times, also performed relatively well in 2009. Therefore, four out of six variables support Friedman's view. In summary and in simple words: Friedman vs. Schumpeter 4:1.⁸

Creative entrepreneurship benefits from stabilisation policy

The analysis of German SMEs during the financial crisis of 2009 allows a clear conclusion to be drawn for economic policy. Crisis hampers entrepreneurial action and largely hinders the process of creative destruction that is necessary for long-term growth and prosperity. Accordingly, creative entrepreneurship would benefit from a stabilisation policy in Friedman's sense.

That does not rule out that a crisis may help some enterprises achieve a breakthrough and that these enterprises then achieve high growth rates. But this does not apply to the average of those enterprises that are typically regarded as rather more dynamic, with the exception of small businesses.

One could argue that the findings reflect the negative consequences of massive economic-policy intervention aimed at combating a crisis. Rather than refuting Schumpeter, they would validate his hypothesis. However, this assumption is challenged by the fact that for the years 2010 and 2011, in which the stabilising effects of the economic policy measures probably only just produced their full impact, no negative growth effects could be ascertained anymore for the enterprises identified as being more entrepreneurial.

Finally, the relatively good crisis performance of enterprises that grew at a slower rate in normal times may be described as hardly surprising. During a crisis, these enterprises apparently reap the rewards for having focused on stability during normal times and for not going the whole distance with their growth possibilities. Their entrepreneurial action was therefore prudent. This observation can indeed be affirmed but it nevertheless contradicts the implication of Schumpeter's theory that in times of crisis it is particularly the dynamic entrepreneurs who get their chance.

The overall finding is, hence, that creative entrepreneurs in particular suffer losses in times of crisis and therefore stand to benefit from stabilising economic-policy interventions. ■

¹ This became evident years before the crisis; cf. Bernanke, B. (2002), On Milton Friedman's Ninetieth Birthday, Remarks at the Conference to Honor Milton Friedman, November 8, <http://www.federalreserve.gov/boarddocs/Speeches/2002/20021108/default.htm>

² As Germany was hit by the global financial crisis but not by the euro crisis, only the year 2009 was identified as a crisis year while all other years were regarded as 'normal times'.

³ The KfW SME Panel (KfW-Mittelstandspanel) has been conducted since 2003 as a postal tracking survey of small and medium-sized enterprises in Germany. The parent population of the KfW SME Panel includes all private-sector companies from all industries with annual turnovers of up to EUR 500 million. With a database of up to 15,000 companies per year, the KfW SME Panel is the only representative survey of the German SME sector and thus the most important source of data on issues relevant to the SME sector. Further information can be obtained at www.kfw-mittelstandspanel.de. For the current report on results see Schwartz, M. (2015): KfW SME Panel 2015 – With growing confidence, German SMEs are starting to invest again, Frankfurt am Main. The survey presented here draws on more than 72,000 observations of some 29,000 small and medium-size enterprises during the period 2003-2012. Entrepreneurial success is measured primarily by the companies' turnover growth rate. The rate of employment growth is used as an alternative yardstick of entrepreneurial success.

⁴ In this context, a number of studies were undertaken which tested whether the global financial crisis hit small and young enterprises comparatively harder than large, established ones. While the results are inconsistent with regard to enterprise age, most young enterprises were identified as more vulnerable to crisis.

⁵ Many small enterprises are long-established and less interested in growth or innovation but all the more interested in stability. The vast majority of enterprises begin their business activity with a manageable size: 89% of all SMEs that have been in business for up to five years have fewer than five employees. However, the overwhelming majority of enterprises also remains relatively small as they develop further. Thus, only 15% of small enterprises with fewer than five employees are less than five years old, while more than one third of small enterprises have been in business for at least 20 years. The average business age of an SME in Germany is just under 20 years. Business start-ups do not need to be initiated by a dynamic entrepreneur either. They may, in fact, be ventured out of necessity, for example when an employee loses their job and moves into self-employment because the opportunity costs are comparatively low.

⁶ One might argue that our variables fail to adequately capture the dynamic entrepreneur. One may even hold the view that the (Schumpeterian) entrepreneur cannot be captured at all by empirical means. That would mean, however, that the hypothesis of crisis as a process of creative destruction is an unverifiable tenet.

⁷ Relative means the smaller the enterprise is, the less pronounced its growth downturn. See also Bartz, W.; Winkler, A. and M. Schwartz (2015), *Kleine Mittelständler stecken Finanzkrise im Jahr 2009 besser weg (Small SMEs handled financial crisis of 2009 better)*, Economics in Brief No. 94, KfW Research, Frankfurt am Main (in German).

⁸ In some robustness tests the 'lead' of Friedman's perspective turns out somewhat smaller, particularly because variables become insignificant. But this has no effect on the basic trend.