

Open Competition and The Entrepreneurial Process

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Abstract

Opening up markets provides both opportunities and challenges to the small- and medium-sized enterprise (SME) sector. It provides opportunities for new and existing firms, encourages entrepreneurship, allows more efficient enterprises to succeed on their own merits, and removes inefficient operators. On the other hand, open competition is often assumed to lead to a situation where large firms “drive out” their smaller competitors, and as a result, some advocates suggest that SMEs should be protected from the rigours of fully open and contestable markets.

This paper seeks to address this issue, using evidence largely drawn from the Australian context and experience. It begins by outlining some of the key arguments for and against open markets, and suggests that, on balance, open competition ultimately helps SMEs. It examines some of the evidence which indicates that competition can often help grow the size of the small business sector, and summarises some recent studies which indicate that most owner-managers are supportive of free and fair competition. However, it also acknowledges that SMEs face some particular challenges in being able to compete effectively, and examines some of the regulatory tools adopted to help SMEs deal with these issues.

Keywords: Antitrust, competition, trade practices, free markets, small business, Australia

Introduction

Competition is an essential ingredient in the entrepreneurial process. Businesses seek to generate income, win sales and gain customers, but there is only a finite amount of these. As a result, all business ventures must engage in a contest for the limited resources (and pockets) of consumers.

Firms engage in a constant process of contestability, differentiation and rivalry as they seek to win customers and generate profits. In the process, those that are more efficient, more attuned to consumer demands, and managed more effectively, will generally succeed.

But competition also comes at a cost. Implicit in the notion of contestability is the fact that there will be both winners and losers. Some firms will succeed, and their owners will be enriched, whilst others emerge second best – which, at the worst point, will mean the business ceases to exist and investment capital is lost.

Competition thus offers both advantages and disadvantages to the small business community. On the one hand, fully competitive markets – free and fair trading environments – provide ample opportunity for entrepreneurs to launch new business ventures, offer innovations, and to carve out successful

niches. On the other hand, however, there is also a perception amongst many existing SMEs that fully open competition allows larger firms to gain greater market share and to squeeze out small-scale enterprises.

As a result, researchers, industry associations and advocates representing the SME community can often present a confusing argument: some argue for deregulation, market liberalisation and freeing up economic structures and markets; whilst others advocate special laws, regulations and economic frameworks to protect existing small businesses.

Is one choice preferable, or are there other ways in which the needs of SMEs can be addressed whilst still maintaining the integrity of open markets?

This paper examines this issue, using evidence largely drawn from the Australian context and experience. It begins by outlining some of the key arguments for and against open markets, and suggests that, on balance, open markets ultimately help SMEs. It examines some of the evidence which indicates that competition can often help grow the size of the small business sector, and data which indicates that most owner-managers are supportive of free and fair competition. However, it also acknowledges that SMEs face some particular challenges in being able to compete effectively, and examines some of the regulatory tools adopted to help SMEs deal with these issues.

The Benefits of Competition for SMEs and Entrepreneurs

Competitive markets can assist small firms and entrepreneurs in a number of different ways. Environments where markets are open to all, fully contestable, and where each firm has the chance to compete on its own merits, give rise to a number of opportunities, including:

- *Product and service diversity:* A range of different goods can be offered to consumers, who may choose (or not) to purchase such items as they see fit;
- *Product/service innovation:* Fully contestable markets create a constant pressure on firms to seek out and introduce viable new innovations that satisfy consumer needs, and which allow them to stand out from their competitors;
- *The development of niche offerings:* The existence of numerous different product offerings can in turn allow small firms to carve out successful markets offering small and highly differentiated goods and services;
- *Efficiency improvements:* Competition also drives businesses to improve their performance by deliberately seeking out better and more effective ways of doing things, which often involves investment in new services, processes and technologies;
- *Launch of new business ventures:* Where entrepreneurs can identify an opportunity to do something new, different or better, then they are more inclined to launch a new firm. High levels of competition, then, should encourage greater rates of new venture formation; and
- *Rewards agile firms:* New and small firms are often seen to be more flexible, nimble and able to respond to change than large organisations. Smaller, flatter management layers and informal, timely decision-making structures should allow SMEs to respond more quickly to market changes and opportunities than their bigger competitors.

In total, these market dynamics tend to foster entrepreneurship – since the ability to adapt and change, be flexible, and embrace innovation remain at the heart of the notion of entrepreneurial activ-

ity, and lay at the centre of Schumpeter's (1934) notion of "creative destruction" and entrepreneurial renewal.

Competition is not, though, an end in itself, or a desirable goal per se. Instead, open competition is desirable because of the broader community benefit which it creates. It provides benefits to consumers, by giving them greater choice and better products. It helps ensure that prices are often lower, and product quality is higher, than would otherwise be the case. By pushing firms towards greater efficiency, the competitive process can translate into higher levels of economic growth, increased employment, greater levels of entrepreneurial activity, and help achieve a higher standard of living for a nation's citizens.

Arguments Against

Not all, however, agree that open markets work to the benefit of SMEs. There is, in fact, a view amongst some small business owners and their representatives that competition can be dangerous to small firms.

In part, this argument springs from the recognition that not all firms have the ability to compete on an equal capacity. For example, as Table 1 below indicates, small firms typically have fewer financial resources, a smaller product range, restricted products and market ranges, and limited access to skilled external advice, which can make it hard for them to effectively challenge bigger competitors. This in turn gives rise to the following criticisms of open markets:

- *Power imbalances between large firms and small firms:* Large-scale corporations have an inherent advantage over small firms, due to the existing financial, human, physical and other resources that they already possess. Large firms, it is suggested, already possess significant market share, high levels of consumer recognition, and have the capacity to therefore edge out (or, in some cases, eliminate) smaller rivals.
- *Inability to compete effectively:* A variation of the above argument is the contention that SMEs are too resource-poor to be able to compete against larger firms.
- *Increased rates of business failure and exit:* Vigorous competition implies that there will be both winners and losers. Those who fail to succeed are often forced to exit the market, with a loss of employment, invested capital and other resources.
- *Market failure.* Not all markets can be contested on an equal basis; sometimes the dynamics or structure of a particular market can mitigate against the competitive process, and result in a monopoly or market with limited players.

Small Business Perceptions of Competition

What, however, do the majority of SME owner-managers think of competition – do they support or oppose it? Whilst only a limited amount of research has been conducted in this arena, the results to date are somewhat surprising.

Table 1: Common Differences In Competitive Capacity Between Small and Large Firms

	<i>SMEs</i>	<i>Large Firms</i>
<i>Number of business establishments</i>	Single	Multiple
<i>Geographical distribution</i>	Limited	Limited or wide
<i>Product/service range</i>	Limited	Limited or wide
<i>Market share</i>	Limited	Significant
<i>Customer base</i>	Small	Numerous
<i>Likelihood of business failure/exit</i>	High	Low
<i>Compliance cost burden</i>	Proportionately high	Proportionately low
<i>Knowledge of, and to access to, regulatory information</i>	Limited; ad-hoc	Sophisticated; extensive
<i>Knowledge of, and to access to, market-place information</i>	Limited; ad-hoc	Sophisticated; extensive
<i>Ability to access established supply sources</i>	Difficult	Easy
<i>Level of financial resources</i>	Typically small and limited	Substantial
<i>Use of external legal and economic advisers</i>	Limited; ad-hoc	Systematic; structured

Source: Schaper (2010)

The Australian Bureau of Statistics (2008a, 2008b, 2009) has examined a number of aspects of small business and their competitive environment. It found that SMEs were more likely than large firms to be concentrated in small, local markets (over 80% relied principally on their local area as their key geographic market); moreover, they were also far more likely to rely on a limited group of clients for their income-generating activities (more than half reported relying on a small number of customers, compared to about a quarter of all large firms). When asked about the intensity of competition that they faced, most stated that they believed themselves to be exposed to a “moderate” or “high” level of competition (although one-third claimed that they faced “minimal” or “no effective” competition). Interestingly, whilst they reported that some 45% of their competitors tended to be larger in size, a further 49% were actually of the same size. In other words, the competitive challenge posed by other small businesses appeared to be just as significant as that presented by larger corporations (ABS 2009).

Perhaps the most detailed examination of SME perceptions of, and support for, the notion of open competition has been conducted by the United Kingdom’s Office of Fair Trading (2005), which has published a number of reports on this issue. For example, an April 2005 study of 2,000 SMEs found that only half were aware of the existence of the *Competition Act*, the principal legislative framework governing competition laws and open markets in the UK (OFT 2005a).

Another OFT study in May 2005, which involved 500 owners and managers in small- and medium-sized firms (but no micro-enterprises), indicated that almost a quarter of all owner-managers believed they were liable to be adversely affected by anti-competitive behaviour such as price fixing and collusion in tender bidding. One third reported an awareness of anti-competitive practices in their industry,

and approximately 20% believed that they had been the victim of anti-competitive activity (OFT 2005b).

Such data would suggest that SME perceive themselves to be victims of occasional anti-competitive practices. Despite this, however, most owner-managers stated that they would be unwilling to report such behaviour to the competition regulator. This discrepancy between perception and action is noted by Storey, who comments (OFT 2005b):

'What is interesting is that even when they experience anti-competitive practices, the reaction of the small firm owner is to soldier on without turning to the authorities. But using their rights under competition laws they can level the playing field to give them a better chance to beat the competition.'

Nevertheless, whilst many SMEs appear to be the victims of one or another types of anti-competitive practices, few owner-managers appear to advocate a retreat from competition to a more closed economy. The same study reports that 75 per cent of SMEs agree with the argument that competition is a driver for innovation and growth, and over 60% support the contention that a competitive environment is a key to winning and maintaining customer loyalty (OFT 2005b). This was also supported by the findings of another OFT study on the perception of competition by SMEs, which in February 2005 found that more than two-thirds of all small firms, and eighty percent of large firms, agreed with the proposition that the "marketplace is sufficiently regulated in relation to fair/open competition" (Synovate 2005).

Opening Up Markets: An Example

Whilst the pro- and anti-open markets perspective can be quite strongly held by some of their respective proponents, there is surprisingly little evidence which examines the practical impact on SMEs of opening up markets. The US Small Business Administration has recently noted (US SBA 2008, p.i) that even though a "...significant body of literature exists on the economic importance of antitrust [competition] laws and enforcement for firms...less is known about [their] impact on small businesses..."

One of the few studies that has examined this issue is the 1995 changes to Australian competition law (Productivity Commission 2005). This is one of the limited instances where there has been a substantial widespread deregulation accompanied by a relatively robust count of SMEs. Up until that year, only companies had been included within the Australian national framework of competition laws; unincorporated sole traders and partnerships, which represented the bulk of all trading SMEs, had been excluded. However, in 1995 a series of national reforms resulted in such firms being incorporated into the national competition framework for the first time. Self-employed professionals such as doctors, for example, were now required to operate and compete with each other; so too were tradespeople and unincorporated micro-enterprises.

In its review of these changes, the national independent economic reform analysis agency, the Productivity Commission (2005), indicated that the changes had actually appeared to encourage the growth of the small business sector. SME numbers continued to grow substantially after the introduction of more competition, and within ten years had more than doubled. At the commencement of these reforms, there had been some 930,000 SMEs in the country; by 2005 there were almost 2 million. Moreover, the proportion of micro-businesses actually rose, from approximately 80% of all firms to

84% (Australian Bureau of Statistics 2007). This suggests that SMEs are not threatened by increased levels of competition and market openness. They can and often do grow rapidly in such conditions.

Setting the Appropriate Competition Framework

A key issue in the overall competition context is the legal and regulatory framework within which business occurs. What sort of structure is needed, and to what extent should SMEs receive special consideration within the competition laws?

All countries have a legal framework which is designed to facilitate competition within their borders (these are referred to as trade practices, fair trading, antitrust or competition law). In general, these laws and regulations seek to set out the “rules of the game” – that is to say, how business can (and cannot) conduct itself in a competitive context. This can include prohibitions on various forms of anti-competitive behaviour (including cartels, market-sharing, and price-fixing), regulations governing monopolies, a framework for assessing inter-firm mergers that could potentially create a substantial lessening of competition, and rules designed to protect consumers (including bans on misleading and deceptive conduct) (Corones 2007).

In Australia, for example, the legal framework is primarily contained within the *Trade Practices Act*¹ (1974). This law deals with a wide range of issues, including restrictive trade practices, consumer protection, mergers and acquisitions, and the regulation of some specific industries and markets (such as shipping, telecommunications, water, and energy). The Act and its provisions are overseen and enforced by an independent statutory agency, the Australian Competition and Consumer Commission (ACCC).

The ACCC’s role is to ensure that individuals and businesses comply with the Act and associated laws. The Commission has capacity to investigate potential breaches of the law, initiate legal action to enforce the Act, undertake an informational and educative role, and to authorise certain potentially anti-competitive behaviour in particular circumstances (ACCC 2008).

The Australian system includes a number of specific provisions designed to take the needs and concerns of SMEs into account. These include:

- *A designated Commissioner responsible for SMEs.* The ACCC has traditionally had at least one full-time Commissioner with a special interest in small business matters and, in 2007, the Act was amended to mandate a Deputy Chair of the Commission “...who has knowledge of, or experience in, small business matters.” This appointment helps guarantee a high level of SME knowledge, and an SME perspective, at the most senior levels of decision-making within the Commission.
- *Mandatory industry codes.* This provision in the Act allows for the development and implementation of industry-wide codes of conduct, and has been used to set up legal frameworks in a number of industries. For example, in 1998 a national Franchising Code of Conduct was introduced, which has made Australia one of the few OECD nations to introduce specific regulations in this sector. Key features of this Code include a requirement on franchisors to provide background information to prospective franchisees, introduce a “cooling off” period before a franchise agreement becomes effective, and provides a mediation service to help settle franchisor-franchisee disputes.

¹ As from January 2011, this will be renamed the *Competition and Consumer Act*.

- *Collective bargaining.* These measures allows small firms and unincorporated individuals to seek authorisation to undertake joint (group) negotiations with a larger firm over matters such as access to supply, contracts, and other commercial matters. It provides participants with legal protection from any potential breaches of the competition laws, although it does not compel the target to enter into negotiations – both parties must ultimately be willing to do so in a voluntary capacity. Chicken farmers, truck drivers, newsagents and a variety of other small-scale business operators have all applied for collective bargaining authorisations in recent years.
- *Prohibition on unconscionable conduct.* The Act also prohibits so-called “unconscionability” – that is, harsh, unjust or unfair behaviour which goes so far beyond the bounds of acceptable commercial behaviour that it cannot be tolerated. Whilst such behaviour can assume many different forms, the prohibition is in part directed towards ensuring that small firms are not treated unconscionably by larger enterprises.
- *Industry consultation and outreach.* The ACCC has a specific staff unit dedicated to SME liaison, which disseminates information, provides speakers to industry groups, and encourages greater levels of business understanding of the law, and of the rights and benefits available under it. The Commission also has a Small Business Consultative Committee and a Franchising Consultative Committee, both composed of representatives from the small business sector, that meet on a regular basis.

Overall, then, the approach has not been to protect small businesses from competition *per se*. Instead, the Act makes some limited specific provisions designed to help address particular SME issues, whilst at the same time maintaining an overall framework that promotes the maintenance of competitive processes. As the Commission has frequently noted, open markets work best when the process of competition is protected and preserved – individual competitors should not be protected, but rather succeed or exit on the basis of their own ability and capacity. The approach has been endorsed by the findings of a federal Senate inquiry into the protection of SMEs in the competition process (2004), which likewise recommended that:

“... the Act can best protect competition by maintaining a range of competitors, who should rise and fall in accordance with the results of competitive rather than anticompetitive conduct. This means that the Act should protect businesses (large or small) against anticompetitive conduct, and it should not be amended to protect competitors against competitive conduct.” (Senate Economics References Committee 2004, p.xi)

Conclusion

Competition poses challenges for all businesses. It removes certainty and replaces it with constant challenges, changes and the need for ongoing responsiveness. However, these same conditions can provide the environment in which entrepreneurs and small firms can flourish, if they have the willingness and capacity to respond pro-actively to such challenges.

As the limited evidence to date appears to suggest, competitive environments can help grow the size of the SME sector, and most proprietors of small-scale business ventures are not opposed to competition. Nevertheless, SMEs do face some challenges in dealing effectively with an open market.

In reality, the choice is not about simply choosing “open” versus “closed” markets. There is a third option - open markets alongside a set of robust laws that take into account the special needs of SMEs.

This is the approach favoured in Australia, where legislation provides SMEs with tools such as collective bargaining, protection from unconscionable conduct and authorisation to help "even up" the competitive playing field, whilst still ensuring that markets are both free and fair.

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