CHAPTER 1

INTRODUCTION

Over the past two decades, many small firms were started (Refer Table 1). Some of these small firms grow and continue to exist until today. They provide a venue for many individuals to be employed in order to sustain livelihood.

Small firms lack the economies of scale available to large firms. However, small firms in various sectors in Malaysia make considerable contributions to the GDP as well as to the employment market in Malaysia.

1.0 Research Background

The progress of society is in many aspects affected by a stable employment market. Mankind as an economic creature needs money as a medium of exchange for basic needs and wants, not to mention the demand for the "extras". Apart from seeking employment in the public or private sectors, an individual could setup his or her own enterprise/firm and become self-employed in order to generate income to sustain his or her livelihood.

The belief that large firms are the cornerstones of modern economy development dates back to the onset of the Industrial Revolution. The theory of the division of labor is propounded by Adam Smith in his famous passage on the pin factory. According to Adam Smith, "One man draws out the wire, another straightens it, a third cuts it, a fourth grinds it at the top for receiving the head……without any of them having been educated to this peculiar business, they certainly could not each of them have made twenty, perhaps not one pin in a day……" (Adam Smith 1976, page 15). Adam Smith's theory provides a clue to the inherent potential of economies of scale in large firms.

In the case of Malaysia, while Vision 2020 sets the goal for Malaysia to be a fully industrialized nation, large firms are looked upon as the engine of growth of the new economy. However, small firms are encouraged to grow, so that they too one day would become big in size.

1.1 Scope of the Study

1.1 What constitutes a small firm?

Small firms are being defined differently by different researcher. For example, Lawrence White (1981) defined small firms as those firms with annual sales at or below US$500,000 or US$5 million (depends on sectors), whereas Catherine Armington and Marjorie Odle (1982) defined small firms as firms with fewer than 100 employees.

On the other hand, Alfred Marshal described the small firm in an interesting analogy to a plant: ".....the young trees of the forest as they struggle upwards through the benumbing shade of their older rivals. Many succumb on the way, and a few only survive; those few become stronger with every year, they get a large share of light and air with every increase of their height, and at last in their turn they tower above their neighbors ...." (Alfred Marshal, 1947, pp 315-316).

In the Malaysia manufacturing sector, the small and medium industries (SMIs) could be classified into two groups:

1. Small scale company: a company with full time employees of not exceeding 50 and an annual sales turnover not exceeding RM10million
2. Medium scale company: a company with full time employees between 51 to 150 employees and with an annual sales turnover of more than RM10million to RM25million

For the purpose of this study, private limited companies registered with the Registry of Companies are regarded as small firms. These small firms may be from the SMI category or other service or trading sectors (except the Professional and Institutional Establishments registered with its own professional bodies[1]). Small entrepreneurs such as sole proprietors and partnerships are registered with the Registrar of Businesses. They are not included in this study due to the difficulty in tracking the operating (active/inactive) status of such operations[2].

1.1.2 Contribution of small firms to the economy

In the case of the Malaysia manufacturing sector, SMIs accounted for about 84% of the total manufacturing establishments in Malaysia even though their contributions to total value-added and employment is approximately 28% and 33% respectively[3].

The Census of Professional and Institutional Establishments[4] (private sectors), 1994, reveals that this group of small firms contributed RM4.1billion in terms of value of gross output and directly employed a total of 88,423 persons.

The Census carried out during the year 1996 on selected service industries"[5], showed that the value of gross output was RM22.5 billion (a 23.0% increase over 1994) and they employed a total of 215,471people (source: Census of selected industries, 1997).

Not to recognize the significance of small firms would be equal to literary blotting out their contributions to employment and national output with a stroke of a pen.

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[1] Source: Census of Professional and Institutional Establishments(Private Sectors), 1994, the professions include accountants,architects, building and draughtsmen, dentist, doctors, engineers, lawyers, surveryors and veterinary surgeons.
[2] Professional and Institutional Establishments are excluded. They do not fall under the authority of ROC or ROB.
[3] Excerpt from foreword by FMM chairman in the FMM SMIs Handbook 1998/99
[4] Source: Census of Professional and Institutional Establishments(Private Sectors), 1994, the professions include accountants,architects, building and draughtsmen, dentist, doctors, engineers, lawyers, surveryors and veterinary surgeons.
[5] Census of selected service industries 1997, Published by Departmentof Statistics, Malaysia, covers 14,918 operating selected sercvice establishments such as: shippingcompanies, real estate agents, bus transport, roadhaulage, cinemas,tourist&travelagencies,shipping agents, stock,commodity and forex brokers, stevedoring companies, advertising agencies,hotels& other lodging places.

1.1.4 Business Cycles[6]

Business cycle is the pattern of upward and downward movements in the general level of real business activity.

Business cycles are divided into four phases, irrespective of their severity and duration. As Figure 1 shows, the four classic phases of the business cycle are:

1. downturn or recession (or depression if the decline in activity is prolonged and severe),
2. trough
3. expansion
4. peak

During the *recession* phase, the level of business activity is in general decline. The various indexes of business activity (building permits, total output, employment, business formation, new orders) indicate that the economy is producing a declining rate of output. The unemployment rate rises, and the number employed declines.

The trough occurs when the various indicators of business activity stop falling. The economy has reached a low point from which recovery begins.

During the *recovery* stage of the business cycle, the various output indicators point to expanding output.

The final stage of the business cycle is reached at the *peak* when the various indicators of production and employment fail to yield further increases.

When the next recession begins, the economy begins another cycle.

[6] (see Roy J. Ruffin and Paul R. Gregory, 1938, reprinted 1990, Principles of Economies, chapter 5).

Figure 1: The Phases of the Business Cycle

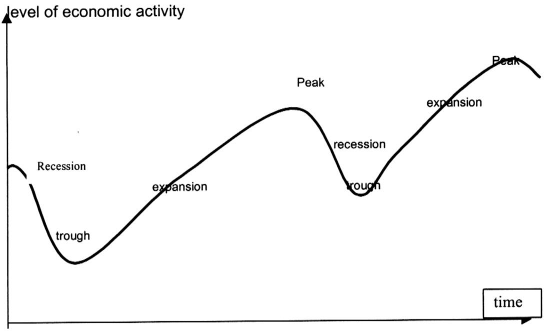
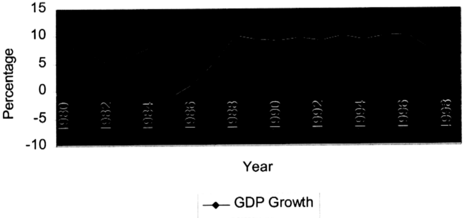


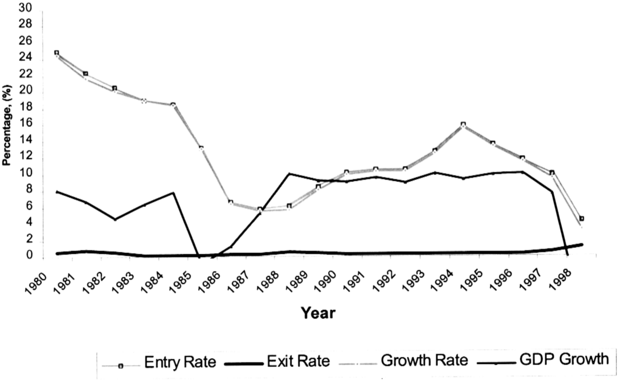
Figure 2: GDP Growth, 1980 - 1998



In the case of Malaysia, the business cycle is depicted in Figure 2. There was a decline in output in 1985 (recession). The GDP growth hit its lowest level at –1.0% (trough) in the same year and then slowly increased from 1986 until it reached the peak in 1996. The period from 1985– 1996 was one business cycle. In 1997 GDP growth started another decline (downturn). It hit the lowest point at –7.54% GDP growth rate in 1998. It signifies the beginning of another business cycle.

The time-series chart on the entry, exit and net growth rate of small firms is depicted in Figure 3(p 8). During the 1985– 1996 business cycle, the net growth of small firms exhibited a declining trend during economic downturn and a growing trend during economic boom period. However, the net growth of small firms "lead" the economy downturn by declining earlier than the GDP. The net growth of small firm "lag" the economy recovery by increasing later than the GDP.

Figure 3: Entry, Exit and Net Growth Rate of Small Firms In Malaysia



1.2 Purpose and Significance of the Study

Small firms are important in stimulating job creation, increasing private consumption, creating new products/services and increasing competition, which would help improve efficiency. Those in the export sector would also be able to contribute more by bringing in foreign exchange.

Thus, being fully aware of the importance of small firms in supporting and sustaining the country's industrialization agenda, the government has undertaken various measures to assist especially the bumiputeras in selected areas such as institutional support and technical assistance for technological advancement, implementing productivity and quality enhancement schemes and the launching of new developmental programs so that the small firms would one day make it to the proud list of large firms.

However, apart from all these assistance, the growth of small firms is in various ways affected by economic variables in the country. There has been much talk about the relationship between inflation and unemployment, GDP growth and employment, but it is probably enlightening to discover the relationship between the growth of small firms in Malaysia in relation to some economic factors during the last business cycle (1986-1998). By knowing the relationship, we could then be able to answer questions such as:

1. To investigate any trends in the startups and closures and the net growth of new firms in relation to the business cycle.
2. The relationship between the net growth of small firms and the economic factors.
3. What type of economic environment is conducive for the development of enterprises?

1.3 Research Hypothesis

It is believed that economic factors such as interest rate, the GDP growth rate, the rate of inflation and the company tax rate have a relationship with the net growth of small firms.

H_0 : There is no relationship between the net growth of small firms and any of the economic factors.

H_1 : There is relationship between the net growth of small firms with at least one of the economic factors.

1.4 Limitations of the study

This study could not distinguish other non-economic factors such as political stability in the country or in the region which might affect the entry and exit rate of companies. Neither could the study distinguish the competitive pressures faced by the producers/distributors of the same goods from different countries which might influence their entry/exit decisions.