**Running Title: Entrepreneurial Firms Competition**

**Entrepreneurial Firms: With Whom Do They Compete, and Where?**

Marc Cowling

College of Business, Law, and Social Sciences

University of Derby

D22 1GB

UK

E-mail: m.cowling@derby.ac.uk

Simon Peter Nadeem

Business School

University of Derby

D22 1GB

UK

E-mail: s.nadeem@derby.ac.uk

**Key Words: Competition; Entrepreneurship; Market Structure; Market Niches; Small Business**

**Abstract**

Many different theories that have attempted to explain why smaller entrepreneurial firms exist. Surprisingly, very little empirical work has tested the obvious questions, such as: Are small firm’s price-takers in highly competitive markets? Who do they compete against? What if they try to raise prices? Does innovation offer niche market protection? Using a large UK data set our key findings are that less than 5% of entrepreneurial firms operate in markets where they effectively have no competition and a quarter of all small firms would lose at least a third of their sales if they raised prices by 10%.

1. **Introduction**

The study of entrepreneurship and entrepreneurial behaviours over the last 40 years has provided some important insights: What entrepreneurial firms do when faced with competition (Dodge, Fullerton, and Robbins, 1994; Lechner and Gudmunsson, 2014; Covin and Slevin, 1989); how their agility can be an asset in times of economic crisis (Bradburd and Ross, 1989); how they can find and defend strategic niches (Papadogonas and Droucopoulos, 2004; Bradburd and Ross, 1989); and the decision to internationalise (Brush, Edelman, and Manolova, 2015; Cowling, Liu, and Zhang, 2016).

But this literature has been strangely silent about formally establishing precisely the markets in which these firms operate (other than international or domestic) and the exact nature of the competition and the prices that they face in these output markets.

 Economics, by contrast, has well established definitions and theories about markets and competition. For example, Robinson (1934) and Stigler (1957) describe the conditions under which perfect competition would exist. Stigler (1964) and Sweezy (1939) define oligopoly. Machlup (1952) describes imperfect competition, and Bain (1956) sets out a context in which barriers to new firm entry exist and hence prevent competition. Chamberlin (1937) describes the theory of monopolistic competition, whilst Baron (1966) sets out the theory of monopoly, and Baumol, Bailey, and Willig (1977) consider the special case of a natural monopoly.

But, since the development of the production function to a large degree excluded a role for the entrepreneur (Cowling, 2003; Niman, 1991), mainstream economics has largely ignored smaller, entrepreneurial businesses from empirical investigation despite a voluminous body of literature that is concerned with the effects of imperfect competition, barriers to entry, and market concentration on the profitability of large incumbent firms (Bain, 1951; Cowling and Waterson, 1976; Conyon and Machin, 1991; Acs and Audretsch, 1987).

In this paper we will empirically quantify just how many entrepreneurial firms operate in competitive markets, how many can compete against large firms, and how many are able to create a genuine market niche through being innovative. In doing so we will adopt the definitions of markets and competition from standard economic theory to give us a well-grounded theoretical basis and point of reference. We hope that our findings will clarify just how many entrepreneurial firms are involved when we discuss different ‘types’ of business and entrepreneurs. Further, we hope that our results may challenge prevailing orthodoxy in economics, and also mainstream management, which has tended to be in thrall to the study of very large, household-name, industrial conglomerates (Pelham and Wilson, 1996).

**2. The Theory of Markets and Competition**

There are four major types of competition and markets considered in economic theory: perfect competition; monopolistic competition; oligopoly; and monopoly. Each has a formal framework that is defined in terms of the information (knowledge) that is possessed by firms and consumers; the ease of entry into (and out of) the market; the uniqueness of the product or service; the ability of a firm to influence the market price; the number of firms in the market; the presence of externalities (potential benefits to third parties not directly involved in a market transaction); and the level of profit. We will briefly discuss the key elements of each type of competition and market, so that we can classify our sample of real entrepreneurial small firms into one of the four classic competitive market structures.

2.1 Perfect competition

A perfectly competitive market is, in many ways a theoretical benchmark market where competition is at its most intense.  Under conditions of perfect competition, consumer welfare is at its highest. The key assumption is that there is perfect knowledge on both the producer and consumer sides of the market and the accumulation of knowledge is costless. For our purposes, this means that the ability of entrepreneurs to pursue risky activities is extremely limited. Building on this perfect knowledge, all market players are assumed to act rationally and in their self-interest. On the producer side of the market, there are no barriers to entry (or exit), and each firm produces homogenous output. Firms are price-takers and cannot influence the prevailing market price. Hence there is no incentive to raise or lower prices. This market is characterised by many firms as there are no barriers to entry and each firm can only make *normal* profits in the long-run. If there are above-normal profits available, and these are observed by other outside firms, then free entry drives the price back to its long-run level.

Under perfect competition, many potential benefits would exist. First, there is no information asymmetry and hence no privileged information that would benefit either party in a transaction. Second, there is no opportunity for firms to derive market power and create supra-normal profits -- through, for example, advertising. Finally, there is maximum allocative and productive efficiency, and consumers in the market have the widest choice of sellers possible. Of course, all of the key assumptions of the theory can be challenged: specifically, perfect information; the existence of identical products; and the ability of consumers and firms to act rationally.

Next we present the three main models that economists refer to under the broad classification of imperfect competition. The first is monopolistic competition.

2.2 Monopolistic competition

The model of monopolistic competition describes a market in which firms have many competitors -- as is true for perfect competition -- but each producer sells a slightly differentiated product. This allows a more fine-grained, and possibly realistic, approach to defining a market, where sellers of a similar product each have the possibility of differentiating their product from those offered by their competitors. An example would be a typical high street with a number of small independent cafes. They all sell coffee and sandwiches, but each has a unique offer that is apparent to potential customers. But importantly, their potential customer base is the same: people who are looking for a coffee or sandwich.

On the seller side of the market, each seller chooses its pricing strategy and output level based on the size of the market and its individual cost base. Information in the market is widely dispersed amongst participants, but may not be perfect. Agents may not know everything, but if they do this does not detract from the general theoretical base. In a monopolistically competitive market there is a role for the entrepreneur as she has to make choices about pricing and output and may operate with or without full market information. However, it also retains some elements of the perfectly competitive market: There is free entry and exit. The firm can differentiate its offer in several ways, including: the physical features of its product; the way in which it markets its product; the type of people it employs; and the sales channels that it operates.

Because each firm can differentiate its product, it follows that firms are price-makers and they can choose the price at which they offer their products to the market. But the firm also faces a downward-sloping demand curve; hence the pricing decision has a direct impact on demand from consumers. Advertising has a role, given that with many competitors each firm needs to convey to potential customers the special characteristics of their particular offer. Finally, the entrepreneur is assumed to seek to maximise profit. In the long-run profits tend towards their perfectly competitive level, but existing firms continually seek to establish the uniqueness of their offering to maintain prices above the competitive level, even in the presence of new entrants. The obvious advantages of monopolistic competition are ease of entry of new firms and a wide choice of differentiated products that are available to (and that are valued by) the consumer. The potential disadvantages are (arguably) wasteful expenditures on advertising and marketing and a more widespread tendency towards productive inefficiency as all economies of scale are not exploited.

2.3 Oligopoly

The theory of oligopolistic markets moves away from perfectly and monopolistically competitive markets -- where large numbers of similar producers are present but each has little market power -- towards a market in which a few large firms have a major share of the total market output, although there can also be large numbers of small firms. In the UK banking industry, for example, there are more than 40 banks operating, but the “big-4” have a market share of customer accounts and lending of around 80%. A measure of market share concentration is often used by economists and competition authorities to identify oligopoly.

Given the small number of major firms in an oligopolistic market, firms’ decisions are not made independently of one another, as was the case under more competitive market scenarios. When a major firm makes its strategic choices, it must also consider potential reactions from other major firms. One particularly interesting choice that these firms face is whether to compete with their main rivals or collude with them. Pricing decisions are also an important strategic choice. Equally, the decision to pursue a new market strategy can give the firm a first-mover advantage; but other firms can pursue countervailing strategies that undermine the initial move, such as developing a better specification product.

Under oligopoly, a firm’s position of market power can be maintained through the presence of barriers to entry, which give incumbent firms an advantage over potential new entrants. One important barrier is economies of scale: New firms are unlikely to enter and attract enough customers to reduce their per-unit costs to the level of larger incumbent firms. Equally important, many of the costs of market entry are sunk and non-recoverable; thus new entrants have to make large investments that are lost if they subsequently exit the market. Further, incumbents with large resource bases can temporarily reduce prices in order to drive new entrants out of the market.

2.4 Monopoly

The purest form of monopoly is when there is a single firm in the market. Some competition authorities adopt a more relaxed definition and consider that a firm has monopoly power (or “market power”) when it accounts for 25% or more of a defined market (Competition Commission, 2016). There are several specific conditions under which a monopoly can occur. These include: (a) a monopoly position being awarded to a single supplier by a government; (b) a situation in which one firm has exclusive ownership of a scarce resource; and (c) where a firm has an exclusive legal right to sell its output through a patent or copyright (and the market demand for that output is sufficiently sizable).

Under monopoly, there is no competition that is present in the market, so firms can maintain profit levels well above the competitive rate. Where no close substitutes are available, this monopoly power is at its greatest. Where there are significant economies of scale present in production, a case can be made that monopoly can be efficient as it avoids inefficient duplication by other firms. There is also an argument to be made that as long as the excess profits derived are channelled back into R&D then there are innovation benefits. But this is contestable if shareholders simply distribute the excess profits. On the consumer side of the market, the lack of choice and above-competitive prices reduce consumer welfare. The lack of competition itself can lead to a tendency to productive and allocative inefficiency as owners face no pressure to follow a cost minimisation strategy. However, we can also think of a spatial monopoly where in a small and rural local market which can only sustain a single hardware store, that single store may in fact be quite small.

Table 1 summarises the key features of the four most common market structures that we have described above. Specifically, we outline: how many firms operate within each type of market; whether there is ease of entry and exit (barriers to entry); the level of competition; and the ability of the firm to set its own prices or accept the exogenously determined market price.

Table 1: Summary of the characteristics of different market models

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | Perfect competition | Monopolistic competition | Oligopoly | Monopoly |
| Number of firms | Large | Many | Few | One |
| Barriers to entrySize of competitor firms | NoneSmall | NoneSmall | HighLarge | HighNone |
| *Common characteristics of market structure* |  |
| Product differentiation | Homogeneous | Differentiated | Differentiated | Single product |
| Market power | Price taker | Some price setting ability | Price setter | Price setter |
| Shape of an individual firm’s demand curve |  |  |  |  |

Source: Department for Business, Innovation and Skills (2016) SME Lending: An International Comparison of Markets. DBIS Research Paper No.270. London.

**3.** **Data and Methodology**

In this section we describe the available data and the way in which we generate empirically testable hypotheses for distinguishing among firms that operate in different types of markets. This study uses data from a UK government sponsored SME survey. Telephone interviews were conducted by OMB (which is a specialist survey company) during August to September 2008, with a sample of businesses that were drawn from with the general SME business population. In total, 1,488 businesses were surveyed. The survey was designed to collect information on growth and market displacement amongst SMEs and, more generally, data on: growth orientation; employment and sales growth; product and process innovation; and entrepreneurial and top management team characteristics such as prior labour market history, formal qualifications, and entrepreneurial experience. Further data were captured that relate to competition and innovation.

The precise survey questions that are of relevance to competition, markets, and innovation are described below.

How would you describe the nature of the competition in your main markets? Would you say that there is…? READ OUT. SINGLE CODE.

Very intense competition 1

Intense competition 2

Moderate competition 3

Weak competition 4

Or no competition at all 5

If your business were to cease trading tomorrow, do you think any of your competitors would take up your current sales over the next year?

Yes, all of our sales 1

Yes, some of them 2

No, no-one would take up our sales 3

**And are your main competitors mostly…?**

 Small firms with less than 250 employees 1

 Or large firms with 250 or more employees 2

 Both small and large firms 3

Now thinking specifically about your own prices, if you were forced by cost increases to raise your prices by 10%, to what extent do you think this would impact on your sales? Would your sales be…?

Please assume that your competitors’ prices remained the same

The same 1

Up to 10% lower 2

11 - 20% lower 3

21- 30% lower 4

Or, more than 30% lower 5

Higher 6

In the last 2 years, has your business introduced any new or significantly improved products or services?

Yes, new products or services 1

Yes, improved products or services 2

Yes, both 3

No 4

Are these just new to your business or are they completely new, and by that I mean that to the best of your knowledge they have not been introduced by anyone before you?

Just new to the business 1

Completely new 2

And still thinking about the last 2 years, has your business introduced any new or significantly improved processes in this time?

Yes, new processes 1

Yes, improved processes 2

Yes, both 3

No 4

Thinking about the types of technology you currently use in your business, would you say that any of this technology could be considered to be ‘cutting edge’?

By cutting edge, I mean technology which is novel or not widely used in your industry sector.

Yes 1

No 2

**Empirical Measures and Tests of Market Structure and Competition**

The answers to these survey questions can be used to provide quantitative characterizations of the market structures that we established above:

*Intensity of Competition* – How intense is the competition in the market? Greater intensity characterizes a more competitive market

*Direct Competition* – what is the size of firms’ competitors? Small = perfectly competitive or monopolistically competitive; large = oligopoly; both=oligopoly

*Prices and Competition* – demand curve effect: price increases lose more sales when the market is more competitive as consumers substitute into competitors’ products

*Differentiation* *and Competition*– innovation is the most common means of creating a differentiated offer. The more innovative is the firm, the lower is the potential for other firms to develop close substitutes

*Differentiation* *and Competition – If the firm was to cease trading, how much of its sales would be taken up by competitors? Higher take-up indicates greater competition*

*Differentiation* *and Competition –* If the firm was to cease trading, would its sales be taken up by small or large firms or both?Small = perfectly competitive or monopolistically competitive; large = oligopoly; both=oligopoly

Table 2 provides these quantitative characterizations and seeks to map them into the more precise market structure definitions. As we are trying to map imperfect survey generated variables to formal market structure definitions we allow for ‘border’ cases by including intermediate categories such as Perfect – Monopolistic Competition and Monopolistic Competition – Oligopoly.

**Table 2: Mapping Empirical Survey Questions to Market Structure and Competition**

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| Survey Question | Perfect Competition | Perfect – Monopolistic Competition | Monopolistic Competition | Monopolistic Competition - Oligopoly | Oligopoly | Monopoly |
| How would you describe the nature of the competition in your main markets?  | Very Intense(24.95%) | Intense(32.10%) | Moderate(31.96%) | Weak(6.80%) | No competition(4.19%) |
| If your business were to cease trading tomorrow, do you think any of your competitors would take up your current sales over the next year? | All(52.53%) | Some (34.79) | None(12.68%) |
| Are your main competitors mostly…? | Small62.61%) | Both(22.36%) | Large(15.03%) |
| If you were forced by cost increases to raise your prices by 10%, to what extent do you think this would impact on your sales?  |  Minus >30%(11.22%) | Minus 21-30%(7.64%) | Minus 11-20%(14.50%) | Minus <=10%(22.99%) | Same(39.20%) | Higher(4.44%) |

From Table 2, we observe that the precise measure adopted to distinguish among the four classic markets is extremely important in terms of allocating each individual firm to a particular market structure. On monopoly, we have more consistency across measures with similar estimates of 4.19% and 4.44% of firms respectively across our intensity of competition measure and our price measure. But the market exit (cease trading) measure gives a higher estimate of 12.68% of firms. Focusing on the two most competitive market structures -- perfect and monopolistic competition -- we get common estimates in the range of 52% -62% of firms across several measures.

An intriguing finding relates to what firms predict if a cost increase forced them to raise prices by 10%. Here 39.20% indicated that they would not lose sales and a further 4.44% indicated that sales would actually increase. Whilst we are offered some reassurance by the relative consistency of our univariate findings across our four key measures which we *ex post* define market structure with, this is nonetheless a puzzle. Why are firms not raising prices even without a cost increase when consumers are perceived to be willing to pay more? The 4.44% may indicate the presence of a luxury good in the sense that raising the price sends a ‘quality’ signal to consumers that their offer is a ‘must-have’ product. Alternatively, it may indicate that the firm operates in a spatially closed rural market where there simply is not feasible alternative within reach. The 39.20% may be at least in part, explained by a more long-run focus on the part of the firm in the same way that banks provide soft loans to new customers in order to lock them in and extract monopoly rents in the future. This is a relationship building strategy, although the ultimate aim is to extract rent from consumers. Or a more simplistic explanation might be that they believe this to be the case but are uncertain enough in their judgements that they are unwilling to try it in practice.

But we are also interested in what types of firms appear to operate under different market structures and hence face quite different competitive pressures. To resolve these questions we estimate a series of econometric models that use the four survey variables which relate to aspects of competition and price by which we can infer potential market characterizations as described above with the use of a vector of firm and entrepreneur demographic variables. The sample statistics for these variables are described in Appendix A. The numerically dominant size class is the micro business with less than ten employees, and three-quarters of firms operate in service sectors of the economy. Three in ten firms use high-technology in their business, and less than one in three engage in either incremental or radical innovation. Boards of directors are very small on average with 2.17 directors, and only 15.0% have a non-executive director. The typical owner is very experienced with more than ten years of business experience. Local markets are served by 54.0% of firms, and only 5.34% sell goods and services internationally. Labour productivity is, on average, £96,252 per employee and there is considerable variation between firms.

As all four of our dependent variables -- competition intensity; competitor take-up if firm exits the market; competitor size; and the price elasticity of demand -- are ordered and categorical, we estimate these models by ordered probit. The general form of each model is thus;

 Firm Characteristics Entrepreneur Characteristics

Y = f ((Age; Size; Industry; Region; Technology; Innovation) + (No. of Directors; Non-Executive Directors; Entrepreneurs’ Formal and Informal Human Capital))

**4. Empirical Results**

In this section we discuss our empirical findings (the details of which are found in Table 3) based on our four market competition models. Having already established the distribution of firms across types of markets against the four measures, we seek to understand more about how firm and entrepreneurial characteristics might shape the nature of this distribution of firms across types of market structure. The first model we consider relates to the intensity of competition faced by the firm in their core market.

4.1 Intensity of Competition

We observe (Model 1) that there is no significant firm size effect on the intensity of competition that a firm faces. Micro, small, and medium sized firms are equally likely to face low (high) levels of competition in their core markets. But there is a firm age effect: Older firms face more intense competition: The older is a firm, the more likely that it is operating under conditions of perfect or monopolistic competition. Younger firms appear more able to shelter themselves from external competition, which offers support for the protected niche hypothesis. There were no effects apparent with respect to technology adoption or the offering innovation products and services. This suggests that there are similar levels of competition in technology and innovation-driven output markets as there is in markets for more conventional products and services.

Firm-level productivity does have a significant impact on the ability of a firm to protect itself from competition. Here the more productive a firm is, the lower is the intensity of competition that it faces in output markets. This is consistent with a cost-advantage discouraging new market entry on the one hand, and forcing inefficient firms to exit.

There are also some identifiable spatial effects. The two most competitive regions of the UK in terms of greater intensity of competition are London and the wider South East. These are the wealthiest regions by a distance in the UK. This may suggest that in high wealth and income regions consumption demand is higher, and this encourages firms to compete with each other with a greater degree of intensity, as well as encouraging new firms to enter to grab a share of a buoyant output market. At the industry level, we find that construction firms, on average, face more intense competition than do their peers in primary, manufacturing, and service-related industries.

With respect to entrepreneurial characteristics, we find that firms with higher levels of internal and external human capital are more capable of protecting themselves from market competition. Specifically, the collective human capital that arises from larger boards of directors, and an external human capital input from a Non-Executive Director (NED) is associated with less intense competition. The actual process by which this occurs is worthy of further research, but is consistent with more talented entrepreneurial teams being able to find and locate protected market niches (Bradburd and Ross, 1989), or as in Porter (1980) protected spatial niches.

4.2 Take-Up of Market Share if Firm Exits

A lower take-up of market share by other firms in the event of a firm exiting the market is indicative of imperfect competition and a heterogeneous product or service offering by the exiting firm such that it is difficult for other firms to provide similar products or services that satisfy the consumers of the exiting firm in that market. We observed previously (Table 2) that 52.5% of firms would have their sales completely absorbed by other firms within a year of exit, which is consistent with a perfectly competitive market, but also that 12.7% of firms would not have their market output replaced by other firms, which is consistent with an imperfect market structure and a highly differentiated product or service offer.

Here again (Model 2) we do not observe any firm-size effects, nor a firm-age effect. Firms that undertook incremental innovations to their offering were more likely to have their market share taken up by other firms, but there were no productivity or industry level effects.

However, there were a number of significant geographic region effects, which suggests that spatial markets are important in this context. Out of the 12 core UK regions (including Greater London), it was the case that in seven regions firms faced the possibility that their entire market would be taken up by other firms within 12 months in the event of their exit. This implies that output markets are more competitive in these regions. The most competitive regional market was Northern Ireland, where incumbent firms were the most likely to have their sales absorbed by other firms. Other more competitive regional markets include London, West Midlands, Yorkshire & Humberside, and to a lesser degree South West, South East, and North West. As there are wide economic disparities across these regions, this does not seem to be associated with wealth and income differences. One potential factor could be relative differences in the spatial costs of serving particular markets.

There were no entrepreneurial effects evident across our basket of entrepreneur and human capital measures. This might suggest that market forces are restricting the ability of entrepreneurs to sustain a competitive advantage through strategic measures in the long-run.

4.3 Size of Competitors

In a general sense, the smaller are the sizes of the competitors in a market, the more competitive a market is. Here small-firm-dominated markets would approximate that of a perfectly or monopolistically competitive market structure. Large-firm competition implies an oligopolistic or at the extreme a potentially monopolistic market structure. Model 3 shows that firm size and age do not allow us to differentiate between firms in terms of the size of their core competitors. In this sense, micro, small, and medium sized firms, and younger and older firms, are equally likely to face small or large firm competition, or indeed a mix of both. Technological sophistication was a differentiating factor, with firms at the higher-technology spectrum being more likely to compete with larger competitors. This suggests that technology adoption allows firms to offset, to a degree, the disadvantages of smallness and youth. But this did not extend to product or service innovation, or indeed to underlying productivity.

Whilst there was a single spatial effect -- firms in the East are more likely to face large-firm competition -- no entrepreneurial effects were found to be significant. This might suggest that the precise nature of the competition that a firm faces in its output market is fairly random -- or at a minimum not able to be captured by the data that were available in this study. Recent empirical work that examines strategic market decisions of SMEs (Cowling and Liu, 2017) found that the preferred form of growth is through expansion within existing markets, and that facing large-firm competition in that market was a major driver of that decision. This suggests that smaller firms tolerate large firms that operate within their output markets, as they do all other size classes of firm, as there will always be an opportunity to expand when the overall market is growing. Oligopoly theory explicitly allows for the presence of a small, competitive fringe as the large dominant firms leave gaps for them to fill.

4.4 Price Elasticity of Demand

Here we test what the potential demand effect is if the firm increased its price by 10% because it faced a 10% increase in its unit production costs. The less demand is eroded -- given the own-firm cost increase -- the more imperfect (uncompetitive) the market structure is perceived to be. To our knowledge Reid (1993) is the only small-firm scholar to have explicitly sought to trace out the small firm’s demand and cost curves by adopting an innovative graphical face-to-face show-card approach.

On firm size effects (Model 4), there are none apparent. But the results show that older firms, facing a cost increase, are likely to have a greater share of their sales eroded. This implies that they face more competitive markets than do younger firms. This is consistent with our competition-intensity findings. Technology adoption and incremental innovation were found to reduce the rate at which sales are eroded given a cost increase, which suggests that they both act to reduce competitive pressure in the output market. Again, as in our competition-intensity model, we observe that more productive firms are better able to protect themselves from external competitive pressures, and, here, to mitigate these cost effects.

Spatial effects were also evident, which suggests that markets have an important regional aspect. Here we find that firms that are located in the East Midlands and South West, and to a lesser degree those in North West and Yorkshire & Humberside, are likely to experience a lower rate of erosion of their market sales given a price increase. In magnitude these spatial effects are quite large which reinforces their relative important in terms of affecting the price elasticity of demand.

**5. Conclusion**

We have formally classified a representative sample of UK SMEs into four classical market structures that are identified in formal economic theory: perfect competition; monopolistic competition; oligopoly; and monopoly. Having allocated our sample of firms into one of the four categories of market, where possible -- with the use of four formal measures that are related to the intensity of competition, the size of competitors, the erosion of market sales on exit, and the price elasticity of demand -- we then shed more light on the factors that influence how firms perceive the characteristics of the markets in which they function. This is important, since the nature of the market and the competition that a firm faces largely determines how efficient it has to be in the first instance, even to ensure basic survival, and how much profit they are able to make.

Our study was inspired by theoretical assumptions -- particularly in neoclassical economics -- that largely exclude the entrepreneur *per se*; and in industrial economics, which largely confines smaller firms to small, local markets and assumes that they operate in fairly standard product markets and compete amongst themselves for the scraps that are left by large dominant firms. It was equally inspired by a large body of the entrepreneurial literature, which tells us a lot about how firms can deviate from their role as assumed by many economic theorists, but tells us very little about the actual and relative distributions of smaller firms within different market structures, and the implications of being in a specific type of market.

Whilst the precise allocation of firms to rigid market structure classifications was imperfect, we are fairly confident in stating that between 50% and 60% of SMEs operate under conditions of perfect or monopolistic competition. That is to say that they produce fairly similar products or services to their small firm competitors and are unable to sustain excess profits in the long-run as new firms can enter their market and erode profit levels back towards the competitive equilibrium. There is also pressure on costs, and any cost increase relative to competitor firms would lead to a significant loss in sales. At the other extreme, between 5% and 12% of SMEs are operating as actual or virtual monopolists in their core market with very little competition or cost pressure.

In terms of what types of SMEs operate under which type of market structure, we consistently found that firm size class *per se* was not a defining factor. But there was evidence that older firms found it more difficult to protect themselves from competition. Utilising state-of-the-art technology was also associated with lower competitive pressures but also large-firm competition. Incremental innovation was more likely to be associated with more competitive market structures. Consistent with standard economic theory, we do find that more productive firms are more likely to operate in less competitive markets -- those that are assumed to be dominated by large firms -- which suggests that the efficient smaller firm can compete even when significant barriers to entry are present.

There was some evidence that entrepreneurial talent, measured by human capital, did allow some smaller firms to position and sustain themselves in less competitive markets. In this sense, the entrepreneurship literature has been heading in the right direction in exploring how this favourable position is achieved and enabled by entrepreneurial inputs for the smaller firm. But our findings are strong only in relation to the breadth of human capital that is available to the firm -- not the individual experience and talent of the entrepreneur *per se*, which is the depth of human capital.

What was clearly apparent was that the spatial (regional) context is very important in the determination of the types of competitive pressure that a firm faces and the presence of close substitutes for products and services. And this is often -- but not exclusively so -- not related to the relative wealth of particular regions, but other region-specific characteristics. Whilst the study of spatial markets has a very long tradition in economics (see Hotelling, 1929, on spatial competition; Salop, 1979, on outside goods price effects; and Panzar, 1980, on contestable markets), this body of theorising -- particularly recently -- has been largely used to identify and explain why competition in markets is easily eroded and how to measure monopoly power in antitrust cases.

**References**

Acs, Z. J., & Audretsch, D. B. (1987). Innovation, market structure, and firm size. *The Review of Economics and Statistics*, 567-574.

Bain, J. S. (1951). Relation of profit rate to industry concentration: American manufacturing, 1936–1940. *The Quarterly Journal of Economics*, *65*(3), 293-324.

Bain, J. S. (1956). *Barriers to new competition, their character and consequences in manufacturing industries* (No. HB771 B23).

Baran, P. A. (1966). *Monopoly capital*. NYU Press.

Baumol, W. J., Bailey, E. E., & Willig, R. D. (1977). Weak invisible hand theorems on the sustainability of multiproduct natural monopoly. *The American Economic Review*, *67*(3), 350-365.

Bradburd, R. M., & Ross, D. R. (1989). Can small firms find and defend strategic niches? A test of the Porter hypothesis. *The Review of Economics and Statistics*, 258-262.

Brush, C. G., Edelman, L. F., & Manolova, T. (2015). The impact of resources on small firm internationalization. *Journal of Small Business Strategy*, *13*(1), 1-17.

Chamberlin, E. H. (1937). Monopolistic or imperfect competition? *The Quarterly Journal of Economics*, *51*(4), 557-580.

Conyon, M., & Machin, S. (1991). The determination of profit margins in UK manufacturing. *The Journal of Industrial Economics*, 369-382.

Covin, J. G., & Slevin, D. P. (1989). Strategic management of small firms in hostile and benign environments. *Strategic Management Journal*, *10*(1), 75-87.

Cowling, K., & Waterson, M. (1976). Price-cost margins and market structure. *Economica*, *43*(171), 267-274.

Cowling, M. (2003). Productivity and corporate governance in smaller firms. *Small Business Economics*, *20*(4), 335-344.

Dodge, H. R., Fullerton, S., & Robbins, J. E. (1994). Stage of the organizational life cycle and competition as mediators of problem perception for small businesses. *Strategic Management Journal*, *15*(2), 121-134.

Fama, E. F., & Laffer, A. B. (1972). The number of firms and competition. *The American Economic Review*, *62*(4), 670-674.

Hotelling, H. (1929). Stability in competition. *The Economic Journal*, *39*(153), 41-57.

Lechner, C., & Gudmundsson, S. V. (2014). Entrepreneurial orientation, firm strategy and small firm performance. *International Small Business Journal*, *32*(1), 36-60.

Machlup, F. (1952). *The economics of sellers' competition: model analysis of sellers' conduct* (No. HB201 M285).

Niman, N. B. (1991). The entrepreneurial function in the theory of the firm. *Scottish Journal of Political Economy*, *38*(2), 162-176.

Panzar, J. C. (1980). Regulation, deregulation, and economic efficiency: the case of the CAB. *The American Economic Review*, *70*(2), 311-315.

Papadogonas, T., & Droucopoulos, V. (2015). Do small firms breathe heavily down the necks of their larger brethren? an empirical examination of the theory of strategic niches. *South-Eastern Europe Journal of Economics*, *2*(1).

Pelham, A. M., & Wilson, D. T. (1995). A longitudinal study of the impact of market structure, firm structure, strategy, and market orientation culture on dimensions of small-firm performance. *Journal of the Academy of Marketing Science*, *24*(1), 27-43.

Porter, M. (1980). Industry and competitive advantage. Free Press. New York.

Posner, R. A. (1969). Natural monopoly and its regulation: a reply. *Stan. L. Rev.*, *22*, 540.

Reid, G.C (1993). Small Business Enterprise: an economic analysis. Routledge. London.

Robinson, J. (1953). The production function and the theory of capital. *The Review of Economic Studies*, *21*(2), 81-106.

Robinson, J. (1934). What is perfect competition? *The Quarterly Journal of Economics*, *49*(1), 104-120.

Salop, S. C. (1979). Monopolistic competition with outside goods. *The Bell Journal of Economics*, 141-156.

Stigler, G. J. (1957). Perfect competition, historically contemplated. *Journal of Political Economy*, *65*(1), 1-17.

Stigler, G. J. (1964). A theory of oligopoly. *Journal of Political Economy*, *72*(1), 44-61.

Sweezy, P. M. (1939). Demand under conditions of oligopoly. *Journal of Political Economy*, *47*(4), 568-573.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Table 3: Regression Models of Market Structure and Competition  | **Model 1** | **Model 2** | **Model 3** | **Model 4** |
|   | **Competition Intensity** | **Sales Erosion After Exit** | **Competitor Size** | **Price Elasticity of Demand** |
|   | **High to Low** | **High to Low** | **Small to Large** | **Low to High** |
|   | coeff | z | Pr>z | coeff | z | Pr>z | coeff | z | Pr>z | coeff | z | Pr>z |
| **Firm Characteristics** |  |  |  |  |  |  |  |  |  |  |  |   |
| ***Size Class*** |  |  |  |  |  |  |  |  |  |  |  |   |
| Small | -0.018 | -0.1100 | 0.9090 | -0.0005 | 0.0000 | 0.9980 | -0.0418 | -0.2300 | 0.8210 | 0.0382 | 0.2300 | 0.8180 |
| Medium | 0.000 | 0.0000 | 1.0000 | -0.4045 | -0.7900 | 0.4270 | 0.4017 | 0.8800 | 0.3790 | 0.0343 | 0.0800 | 0.9370 |
| Firm Age | -0.008\*\*\* | -2.6000 | 0.0090 | -0.0028 | -0.9800 | 0.3260 | -0.0011 | -0.3100 | 0.7530 | 0.004\* | 1.6900 | 0.0910 |
| High-Tech | 0.047 | 0.6700 | 0.5020 | 0.0812 | 1.0000 | 0.3180 | 0.244\*\*\* | 3.0100 | 0.0030 | -0.327\*\*\* | -4.4200 | 0.0000 |
| ***Innovation*** |  |  |  |  |  |  |  |  |  |  |  |   |
| Incremental | -0.146 | -1.4000 | 0.1600 | -0.273\*\* | -2.2200 | 0.0270 | -0.0818 | -0.6600 | 0.5080 | -0.278\*\* | -2.5000 | 0.0120 |
| Radical | 0.018 | 0.2100 | 0.8330 | 0.0617 | 0.6500 | 0.5160 | 0.1191 | 1.2400 | 0.2160 | -0.0075 | -0.0900 | 0.9310 |
| Productivity | 2.23E-10\*\* | 2.0700 | 0.0390 | -3.76E-11 | -0.3100 | 0.7580 | -1.76E-10 | -1.3800 | 0.1690 | -3.55E-10\*\*\* | -2.9600 | 0.0030 |
| ***Industry*** |  |  |  |  |  |  |  |  |  |  |  |   |
| Construction | -0.432\*\*\* | -3.3300 | 0.0010 | -0.1788 | -1.2200 | 0.2230 | 0.1760 | 1.1500 | 0.2500 | 0.0252 | 0.1900 | 0.8520 |
| Services | -0.138 | -1.2600 | 0.2070 | -0.1350 | -1.0900 | 0.2770 | 0.1829 | 1.4000 | 0.1600 | -0.0069 | -0.0600 | 0.9520 |
| **Entrepreneurial Characteristics** |  |  |  |  |  |  |  |  |  |  |  |   |
| Board Size | 0.047\*\* | 2.2900 | 0.0220 | 0.0078 | 0.3400 | 0.7360 | -0.0258 | -0.5800 | 0.5590 | -0.124\*\*\* | -3.2600 | 0.0010 |
| NED | 0.373\*\*\* | 3.3400 | 0.0010 | 0.0408 | 0.3200 | 0.7530 | 0.1051 | 0.7900 | 0.4290 | 0.0349 | 0.2900 | 0.7710 |
| Years business experience | -0.011 | -0.5900 | 0.5580 | 0.0241 | 1.0900 | 0.2770 | 0.0265 | 1.1600 | 0.2450 | 0.0269 | 1.3100 | 0.1910 |
|   |  |  |  |  |  |  |  |  |  |  |  |   |
| plus region + market | Yes |  |  | Yes |  |  | Yes |  |  | Yes |  |   |
|   |  |  |  |  |  |  |  |  |  |  |  |   |
| n obs | 1,271 |  |  | 1,160 |  |  | 1,229 |  |  | 1,130 |  |   |
| Log Likehihood | -1,670.32 |  |  | -1,079.85 |  |  | -1,036.00 |  |  | -1,725.68 |  |   |
|   |  |  |  |  |  |  |  |  |  |  |  |   |
| cut 1 | -1.0012 |  |  | -0.3388 |  |  | 0.8979 |  |  | -2.1795 |  |   |
| cut 2 | -0.1120 |  |  | 0.8050 |  |  | 1.6983 |  |  | -0.5318 |  |   |
| cut 3 | 1.0707 |  |  |  |  |  |  |  |  | 0.0717 |  |   |
| cut 4 | 1.6103 |  |  |  |  |  |  |  |  | 0.4628 |  |   |
| cut 5 |   |   |   |   |   |   |   |   |   | 0.8441 |   |   |

Appendix A: Variable descriptive statistics

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | **Mean** | **Std. Dev** | **Low** | **High** |
| **Firm Characteristics** |  |  |  |  |
| ***Size Class*** |  |  |  |  |
| Micro | 64.58 |  |  |  |
| Small | 28.83 |  |  |  |
| Medium | 6.05 |  |  |  |
| Large | 0.54 |  |  |  |
|  | 100.0 |  |  |  |
| Firm Age | 4.12 | 6.09 | 0 | 208 |
| High-Tech | 30.31 |  | 0 | 1 |
| ***Innovation*** |  |  |  |  |
| None | 71.98 |  |  |  |
| Incremental | 10.48 |  |  |  |
| Radical | 17.54 |  |  |  |
|  | 100.0 |  |  |  |
| Labour Productivity £s | 96,252.74 | 166,977.20 | 5,714.29 | 330,000.00 |
| ***Industry*** |  |  |  |  |
| Primary - Manufacturing | 19.15 |  |  |  |
| Construction | 5.58 |  |  |  |
| Services | 75.27 |  |  |  |
|  | 100.0 |  |  |  |
| **Entrepreneurial Characteristics** |  |  |  |  |
| Board Size | 2.17 | 3.95 | 1 | 135 |
| NED | 15.00 |  | 0 | 1 |
| *Years business experience* |  |  |  |  |
| None | 4.57 |  |  |  |
| <1 year | 2.05 |  |  |  |
| 1-3 years | 13.52 |  |  |  |
| 4-6 years | 18.43 |  |  |  |
| 7-9 years | 10.38 |  |  |  |
| 10-15 years | 19.25 |  |  |  |
| >15 years | 31.81 |  |  |  |
|  | 100.0 |  |  |  |
| **Spatial Markets** |  |  |  |  |
| Local | 54.01 |  |  |  |
| Regional | 14.21 |  |  |  |
| National | 26.44 |  |  |  |
| EU | 2.32 |  |  |  |
| World | 3.02 |  |  |  |
|  | 100.0 |  |  |  |