



# HUMAN CAPITAL AND STRUCTURAL UPHEAVAL: A STUDY OF MANUFACTURING FIRMS IN THE WEST BANK

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## EXECUTIVE SUMMARY

*Firms in various worldwide locations are repeatedly subjected to radical political, economic, and social upheavals, including changes in administrative governance, new economic paradigms, natural disasters, and warfare. Perhaps because of the difficulty of conducting research in these environments, little is known regarding the unique requirements of entrepreneurs and their business organizations in such troubled locations. Reliable research and information is necessary in order to design and assess methods of providing institutional support both during, and after, such turmoil.*

*Based on data collected from field interviews over a six-month period, this article examines the characteristics of the owners of 64 small manufacturing businesses that have undergone or were experiencing radical political and economic upheaval in the West Bank town of Ramallah in the Palestinian Territories. The objective of the study is to examine characteristics that influence and assist an entrepreneur's resource allocation decision-making processes. This was done by comparatively assessing the effects on profitability of both firm and individual assets in a highly constrained rapidly changing environment. Understanding this allocation process will lead to more effective targeted assistance in regions experiencing or exiting environmental transitions and upheavals.*

*Human capital theory is utilized in this study as a framework for understanding the comparative response of owners to reallocate resources under the stressful environment of the pre- and post-intifada West Bank territories. While human capital has been well studied in literature examining resource allocation in "typical" competitive environments, our understanding of the influence of human capital in transitional environments is quite limited.*

*This study provides some useful, and perhaps surprising results, from both theoretical and practical perspectives. Owner's human capital (coded from formal education) was found to impact profitability*

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only with the micro firms studied (those with three or fewer employees), however, it is possible that this finding reflects dilution of human capital in comparatively larger small and medium-sized enterprises (SMEs). One interesting departure from similar studies is that experience was not found to affect the profitability of the firm. Plant capital, on the other hand, was found to be associated with the profitability of only larger SMEs, controlling for business age and experience of the owner. This finding is significant because, presently, institutions such as the World Bank, NGOs and national development agencies focus their efforts primarily on providing credit to small businesses, whereas training and education currently are somewhat out of favor.

A model is proposed in this study comparing resource requirements according to both the size and the productivity/technological level of the firm. The object is to explain the reduced importance of human capital and experience in environments of radical transition, specifically the arbitrary nature and lack of predictability of transitional governance, and the increased importance of financial capital only with large SMEs. It is argued that skills acquired in functional expertise do not necessarily prepare an entrepreneur for the abrupt environmental transformations characteristic of tumultuous political events. This research suggests that owners are in a better position to maximize their cognitive skills in decision making within smaller organizations. However, these skills are naturally diffused and so less effective at influencing the outcomes of somewhat larger organizations. Larger SMEs are necessarily more capital intensive and more bureaucratic, and so the cumulative human capital at the organizational level may be more important to allocative efficiency than the human capital of the individual firm owner. Further, larger SMEs require organizational expertise that may not be captured in the individual level characteristics of entrepreneurs.

This research suggests that efforts to support such environments should carefully consider the size of the firms in question before designing and implementing programs of assistance, differentiating microenterprises from small businesses. In particular, the findings of this study suggest that smaller firms experiencing rapid environmental upheaval will benefit most from formal education, training and advice. Larger firms, in contrast, appear to benefit most from loans providing traditional capital support, and from advice across the entire firm's human capital base, particularly regarding organizational management and delegation skills. © 2001 Elsevier Science Inc.

## INTRODUCTION

What happens to small business and entrepreneurial ventures when the "rules change" due to political, social, and legal transformations? Which entrepreneurs are best able to negotiate radical environmental changes? This study examines the characteristics of the owners of 64 small manufacturing businesses that have undergone radical political and economic upheaval in the West Bank town of Ramallah, in the Palestinian Territories.

While considerable literature examines the societal entrepreneurial climate in terms of environmental suitability toward the promotion of new ventures and small businesses (Kets De Vries, 1997; Hannan and Freeman, 1977; Gartner, 1985), the study of small business in environments experiencing radical administrative change and societal upheaval has been scant. Limited reports suggest that such radical change can virtually devastate an entire generation of entrepreneurs (Dana and France, 1996; Shahwan, 1993). In the former Soviet Union the outcomes include ethnic divisiveness, consumer desperation, and widespread business corruption (Gubin et al., 1993).<sup>1</sup>

In general, studies comparatively examining factors affecting the success of small

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<sup>1</sup>The unique history of the former USSR suggests that a tradition of ruling elites and authoritarianism is responsible for the inability of the market system to take root, with increasing attention being placed on ethical dimensions that form obstacles to entrepreneurship (Puffer and McCarthy, 1995).

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