*Center for the Study of Minority & Small Business*

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# VERY SMALL BUSINESS CREATES VERY LARGE CHANGE

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***Abstract:*** *The SBA definition of small business includes companies with up to 500 employees, and SBA programs typically focus on those with more than 20. Private investment and public policy generally target the same group of companies in selling goods, services, and financing. However, the real heart of job growth in the small business community is businesses with fewer than five employees. Addressing the needs of this segment can generate profound positive economic and social consequences.*

We have become used to hearing the phrase that "small business is the economic engine of the economy." Most recently, it has become the mantra of the new Obama Administration. But what does it mean? And what does it imply for economic and social policy?

A study of net new jobs provided by small businesses over the lifetime that the U.S. Bureau of the Census kept the data yields surprising answers about the size and impact of this business segment.[1] It shows that overall, very small businesses have created literally all the new jobs.

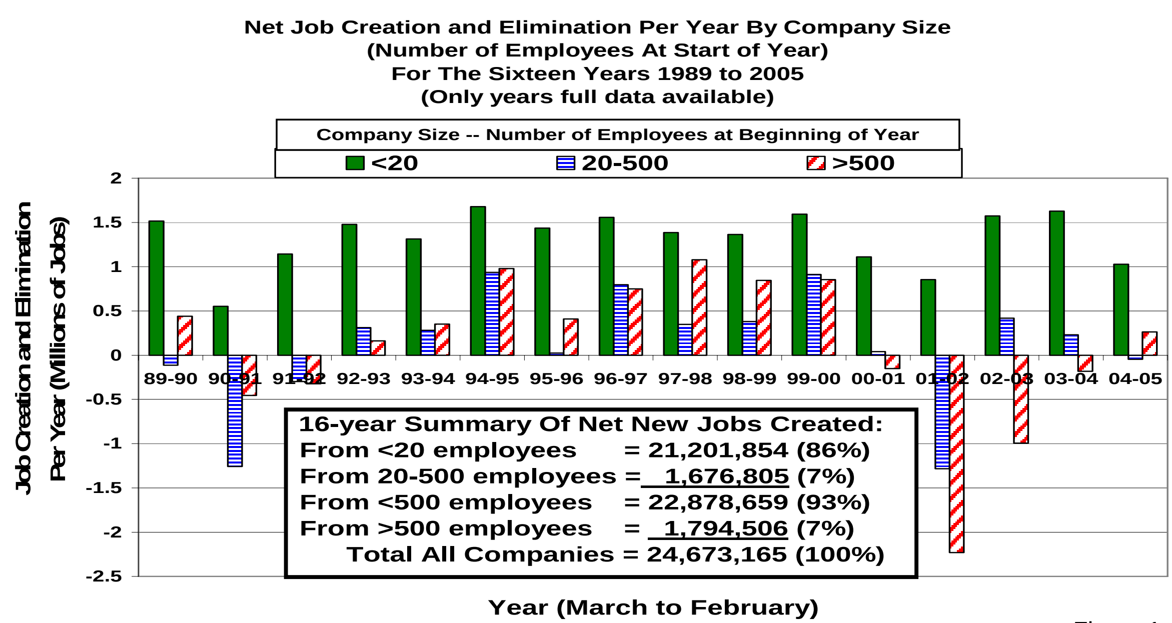


Figure 1

[1] The principle data used in this essay were compiled by Terry Bibbens for the Small Business Technology Council of the National Small Business Association, using two sources: A) Office of Advocacy, U.S. Small Business Administration; http://www.sba.gov/advo/research/dyn_b_d8905.pdf, a longitudinal dynamic study on the period 1989 to 2005, and *Small Business Profiles for the States and Territories*, 2008; and B) A study by Alicia Robb at Advocacy, http://www.sba.gov/advo/stats/m_a.pdf, covering the period 1990 to 1994, which addresses mergers, acquisitions and "border crossers;" those companies who grow above the 500 employee level. Data collection of this type started in 1989 and is only available through 2005. Since 2005, the Office of Advocacy has published a state by state analysis of job creation. All statistics used ultimately derive from the U.S. Bureau of the Census, http://www.census.gov, and have been verified with them.

Note that Figure 1 identifies **net** new jobs.  Net new jobs comprises those jobs that remain after firings, quittings, layoffs, and downsizings; plus business start-ups, collapses, mergers, and acquisitions.  The baseline for the size of the company reported is the number of employees in the firm at the beginning of the year in March.

Here is the same information rendered as a simplified line graph.

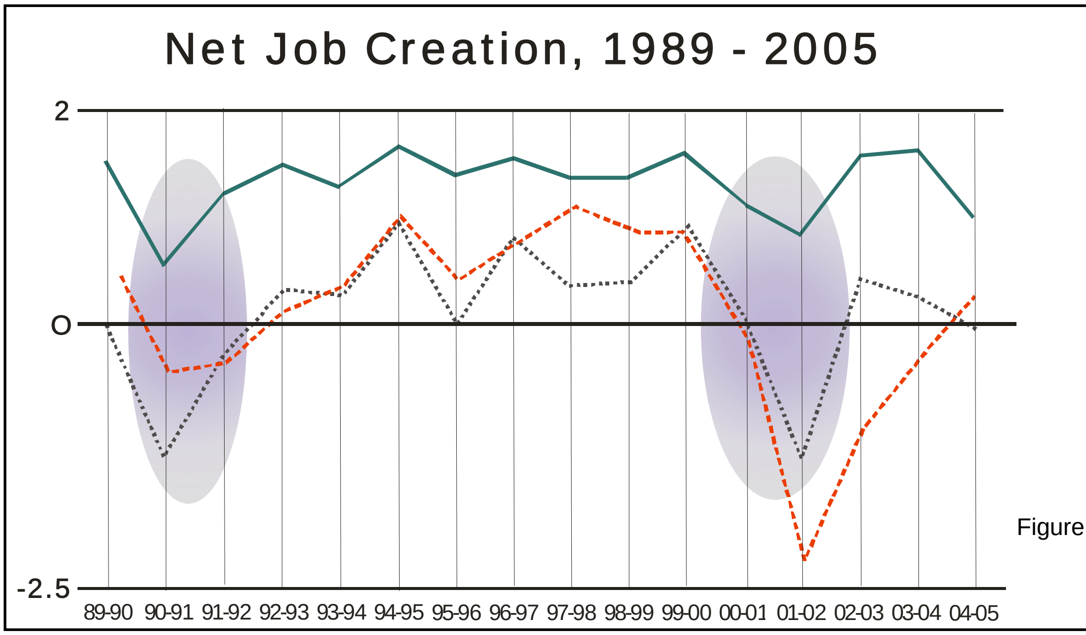

Figure 2

Figure 2 shows graphically that without fail, during the term of the analysis in Figure 1 companies with less than 20 employees dramatically lead in job creation.  No matter what the state of the general economy, businesses with less than 20 employees never fail to surpass all other categories.  They account in aggregate for 86% of all new jobs and 92% of the jobs created by all small business.  During the same period, small business itself accounts for 93% of all net new jobs created by businesses of every size.  It also is worth noting that in particular years, such as those following the collapse of the new economy bubble in Silicon Valley, small businesses accounted for over 100% of all new jobs, as major industries collapsed.

The lowest category of "number of employees" in the Census data throughout this period is 20. Finer cuts of data simply were not available until recently.  Since 2002, more detailed data has become available, allowing us to disassemble the smaller business categories into companies with 1-4, 5-9, 10-19, 20-99, and 100-499.[2]  Figure 3 below looks at net job development in that more detailed way.

[2] For this analysis, we distinguish between microbusiness (MB), businesses without employees; very small businesses (VSB), businesses with 1-4 employees, small businesses (SB), with 5-99 employees, and small to middle-sized businesses (SMB), with 100-499 employees.  This is not the SBA "official" definition, but it provides labels for interpreting the statistics below.  It also should be noted that this form of categorization is consistent with international labeling practices, in which businesses with 1 to 4, 5, 6, or even 10 employees are seen as small business, and larger ventures are denominated Small-Medium Enterprises (SME).

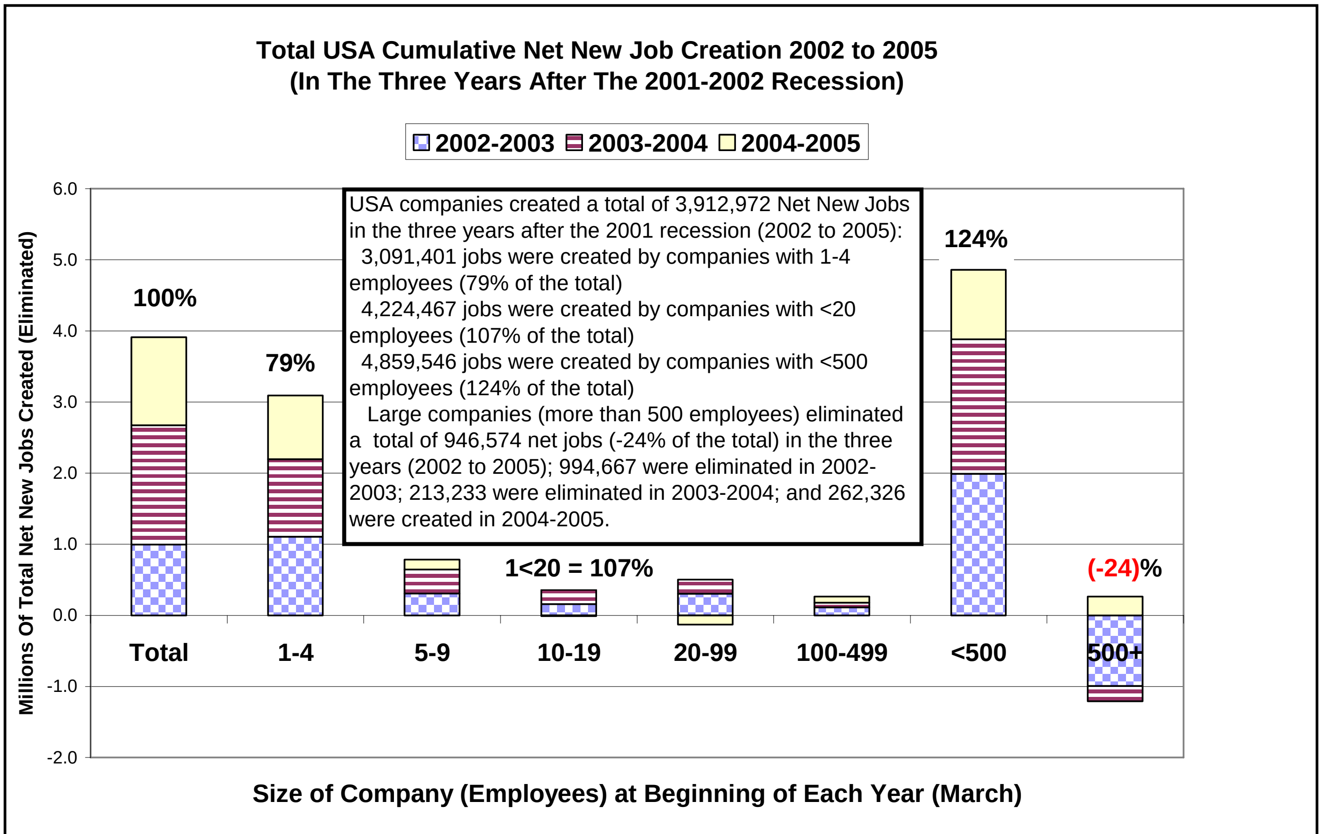

Figure 3

Consistent with Figure 2, in the three years studied, small business has accounted for over 100% of net new jobs, while large business failures, mergers, and acquisitions resulted in downsizing and consistent net job losses.

This is not an anomaly. We compiled the same data for every state. Each chart looks more or less the same as the chart above. Net new job creation in California for the three years 2002-2005 are shown in Figure 4 below.

In the state charts, the number of jobs per state differs from one to another, but in each case, the overall pattern is the same. The category of 1-4 employees (VSB) mimics the total employment picture and leads every other category of employment by far, creating about 79 percent of the total net new jobs. Middle market and large businesses, those with over 500 employees, act as a drag on new employment eliminating about 24 percent of the net new jobs created by the small businesses. Businesses between 5 and 499 are less consequential; however, they contribute about 40 percent of the total net new jobs (one-half of that created by the 1-4 employee businesses).

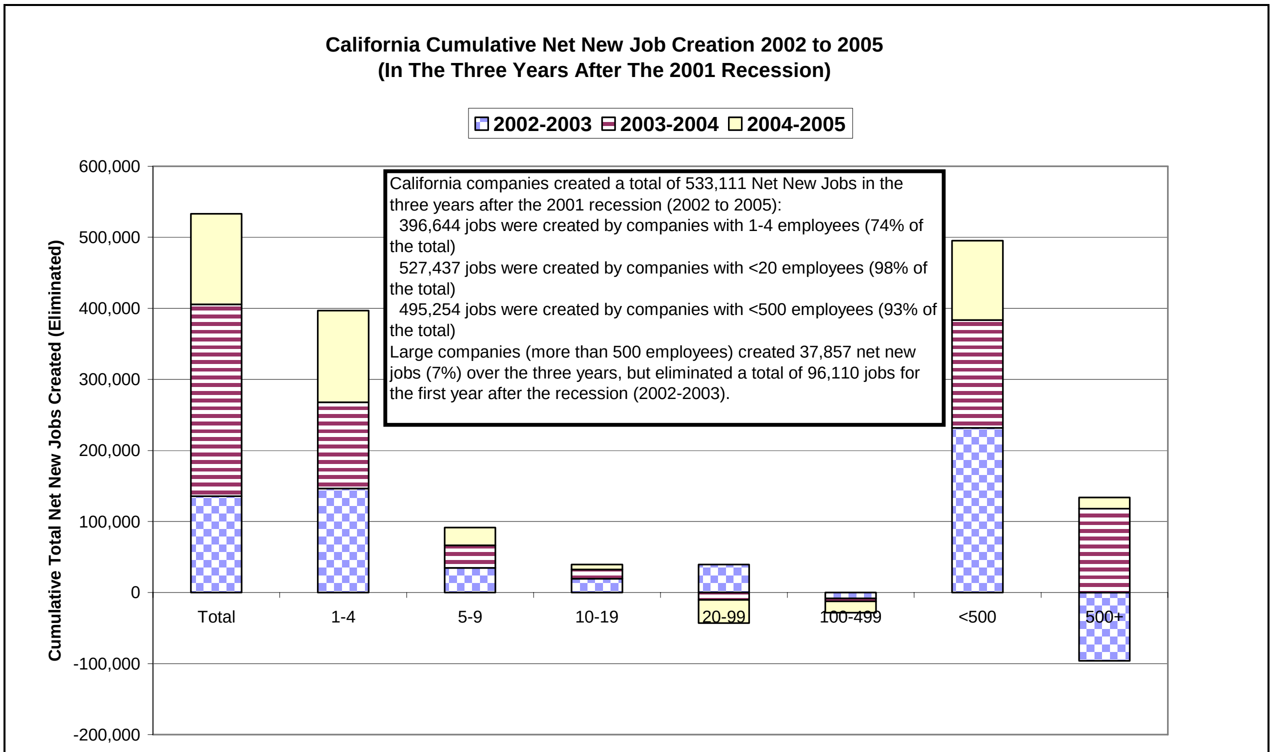

Figure 4

There are a few exceptions. In states with small populations and large federal labs run by universities, such as New Mexico and Utah, large company new job creation looks stronger. In Alaska large extraction industries and Native American ownership presents a slightly different picture. However, that in states with large populations, like California, federal laboratory/ university employment and the existence of very large industries makes little impact.

What accounts for the power of VSBs to create new jobs? One reason is the sheer number of them.[3] In 2007 there were 27.2 million small business altogether, of which over 6 million had employees, with over 95% falling into the SMB category. In that same year about 637,100 new businesses with employees started up. While 588,600 left the category through failure, growth or acquisition, small business in general has shown steady growth in every year statistics have been kept.

Of the small businesses in the United States, 28.3% are women owned, with another 7% jointly owned by women and men. Minorities accounted for another 16.2%. That is because these segments of the population suffer higher rates of unemployment in traditional companies and

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[3] All following analysis based directly on SBA Office of Advocacy statistics, current to 2006 and 2007, which can be examined at http://web.sba.gov/faqs/faqIndexAll.cfm?areaid=24. This summary sheet reflects data and conclusions from numerous longer studies by the Office in 2008-09. See also Robert Fairlie, *Contributions of Immigrants to the U.S. Economy*, 2008, *Characterization*, 2008; William Parsons and Spencer Teracy, *High Impact Firms: Gazelles Revisited*; and Darrene Hackler, et. al., *Human Capital and Women's Business Ownership*.

need other ways to earn money.  Hence, almost all startups and the vast majority of minority businesses fall into the category of VSB and are even more strongly represented in that category than mainstream ones.  Minority and women owned small businesses play an even more significant role in California, where their number and percentage lead the nation by double the next state, New York.

These data suggest VSBs represent an even more important option to traditional employment during "hard times," whether officially defined as a depression, recession, economic downturn, burst economic bubble, or slowed economy, especially for those most sensitive to economic disruption.  That is not dramatic news.  What is surprising is the degree to which small business leads the country out of such times.[4]

Recessions and depressions have characterized the American economy periodically since 1893. During the era for which we have small business statistics, we have been in recession or depression according to official definitions in 1990-91, 2000-01, and today.  Each succeeding downturn has been deeper and more enduring then the last.  A look at the recession years marked in Figure 2 shows that VSB takes a hit at the onset of the recession, declining about as steeply as the other sectors, its fall feathered by the process of changing from traditional to self-employment.  Then, in each case, VSB recovers fastest to lead the country out of the downturn. In fact, in the prolonged recession following the collapse of the new economy bubble, VSB is the only healthy sector.  It takes the SB, SMB, and large business sectors much longer to recover.

Practical experience backs this up.  In the 1987 recession prior to the keeping of these statistics by the SBA, when the aerospace industry fell apart in Los Angeles the wake of its collapse took down many large companies and far more smaller ones that supplied them. It was the diversity of small businesses, and especially VSBs, that not only pulled Los Angeles out of its recession, but in fact transformed Los Angeles business into the shape it has today.  No longer an aerospace-dependent economy, the region is a far more diversified one based in fashion, toys, furniture, and numerous other sectors, and one dominated as not other place in the country by small business.[5]

Small businesses tend to lead economic growth, whereas large firms tend to follow it.  Among small businesses, VSBs come into being to meet immediate and local needs or to develop new or emerging markets by using innovation and technology.  They tend to make markets.  Large businesses tend to shy away from small or unestablished markets.  They most frequently do not make investments until they are fairly certain that markets exist, conducting long studies and spending heavily to break into a market that already has been "pioneered" by smaller and bolder

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[4] See Brian Headd and Padwan Saade, *Do Business Definitions Destroy Small Business Results,* SBA Office of Advocacy, for a discussion of hour business type and sector impact the results of small business studies.  While important as a general correction to small business statistics, Headd and Saade's conclusions do not affect this study.

[5] This analysis is documented in Philip Borden, "The Growth Of Women Owned Business In America:  Reasons, Results, And Ramifications" Western Academy of Management, Shizuoka, Japan, 2000, and Denise Fairchild, et. al, *Southern California Minority Business Atlas*, 2000.

ventures.  Whereas employment in VSBs tends to occur at the front end of a developing market, hiring by larger firms tends to occur in markets that already are mature or nearly mature.[6]

VSBs also have fewer choices in how they handle adversity.  They often have roots in the communities they serve, and being smaller they have fewer cash reserves.  Their owners, often fugitives from traditional employment, cannot always go back to it.  While the need to persevere hurts the cash position of VSBs, it allows—often requires—them to stay in the communities in which they were founded.  Larger firms, viewing a coming or actual downturn tend to react by downsizing, seeking to be acquired, closing non-performing facilities, etc.  They may have more cash, but are neither as flexible nor as rooted.

Although it is a truism of surviving hard times not to compromise growth by cutting back talent or technology, large companies, often burdened by layers of management, tend to "pull in their horns" and make fewer such investments in economic downturns.  VSBs are more agile than large businesses in reacting to change.  This flexibility is a function of size, temperament, and organization.  In VSBs, the creators and managers often are the same people, and maintaining an innovative edge is the only way they can persevere through hard times, so they are better positioned to lead when difficult economic situations ease.

What does the power of VSB imply for government policy development?  It suggests that loans by entities like SBA should become smaller, more accessible, easier to acquire, and quicker to fund.  The average SBA loan targets much larger ventures at present.  If its 504 program is included in the average, with its focus on equipment and real estate, an almost infinitesimal percentage of SBA's overall portfolio is devoted to VSBs.

Yet, if employment and economic development are an SBA program goal, VSBs are precisely where the bulk of loans should go.  Moreover, SBA intermediaries and lenders should consider more innovative forms of collateralization, such as customer orders and contracts, and receivables, instead of the rigid collateral rules that now obtain. Higher bank loan guarantees by SBA also could have a very positive effect on encouraging banks to lend to VSBs.   State economic development efforts targeted to VSBs also could have a positive effect on employment growth and all it brings.

Loans for less than $25,000 should be a major push, and lending terms should incorporate patience or novel methods of repayment, perhaps with moratorium periods built in for periods of hardship that meet preconditions specified in the original loan covenants.  Worldwide, microloans have become a driver of economic development, serving audiences similar in size and prospect to VSBs.  They have carried high interest to offset provider risk, and have used the power of the Internet to achieve economies of scale among both borrowers and lenders.

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[6] Each year, IBM conducts interviews with over 1,000 selected CEOs and publishes a report of their opinions on a variety of topics.  The latest study, *The Enterprise of the Future:  IBM Global CEO Study*, 2008, is consistent with the prior ones in the CEO's admiration of the flexibility, rapid response to innovation, organizational fluidity, and increasing social and environmental responsibility that far more often characterize small business.

A similar strategy to that outlined above could be followed by city and county community development departments, which by and large have turned away from entrepreneurial training and VSB funding. It is anticipated that the Obama Administration will pour added funds into the Community Development Block Grant (CDBG) programs used by metropolitan and rural areas to stimulate economic development. Until the last decade or so, CDBG funds often were used in this way. It is time to revisit that program. The Departments of Commerce, Housing and Urban Development and Health and Human Services have created disaster loan funds and revolving loan facilities that until the past few years have been remarkably effective in building or restoring businesses at the bottom.

City and county governments should take another hard look at the business permitting processes to make them as simple as possible for founding VSBs. Entrepreneurs with fewer than four employees typically do not have time or resources to work with complex permitting processes to start and grow businesses. Getting VSBs up and running quickly and easily returns income and employee taxes to state and local governments all the faster. And every successful business in a community adds secondary and sometimes tertiary jobs. These represent powerful incentives for helping us to grow out of recessions.

It often is pointed out that it takes as much overhead and paperwork to fund a small loan as a large one. However, reducing front end requirements and complexities for applying for loans reduces that cost. In the commercial world, a successful program by Union Bank advanced $5,000 loans based on graduation from a recognized nonprofit entrepreneurial training program and made the nonprofit responsible for overseeing the application and screening process. It was not charity, but good business. Its underwriting costs on such loans approached nearly zero. Union Bank calculated that even if many loans turned toxic, on balance its losses would be less than its costs for underwriting the loans without the entrepreneurial training nonprofits. And on the upside, successful borrowers became good customers as their businesses grew. For the nonprofits, the cost was minimal and often part of their charter.

Finally, VSBs hold often unrecognized promise for commercial enterprises. American Express has recognized this explicitly and become the largest business lender. In fact, over 50% of businesses begin with credit card debt, and almost all new ventures end up supported by friends and family. Beyond finance itself, when a new business is formed, it needs almost every form of good and service, from simple things like pens and paper, to computers, computer networks, and legal advice. Office supply companies, communications companies, and others have missed out on a hungry market that grows in hard times as those unsuccessful at seeking employment turn to self employment and VSBs to earn their living. Changing advertising and sales patterns to focus more on VSBs could in and of itself become both a profit driver for suppliers and an overall economic stimulus.

Local governments, economic development organizations and university entrepreneurial programs can be supportive of net new job creation by starting training programs for new entrepreneurs. This has been quite effective in past recessions in the Los Angeles and San Diego regions.

In sum, it is time to look at VSBs with fresh eyes, especially in these times of economic malaise and tectonic political and economic change. It is VSBs that really fuel the economy. Fuel their proliferation and growth and significant economic and social multipliers should follow.

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