

## 1.2: Small Business in the US Economy

### LEARNING OBJECTIVES

1. Explain the significance of small business in American history and the US economy.
2. Define small business.
3. Explain how small business contributes to the overall economy.
4. Explain how small business impacts US employment

It's an exciting time to be in small business. This is certainly not anything new, but you might not know it. Scan any issue of the popular business press, and in all probability, you will find a cover story on one of America's or the world's major corporations or a spotlight on their CEOs. Newspapers, talk radio, and television seem to have an unlimited supply of pundits and politicians eager to pontificate on firms that have been labeled as "too big to fail." Listen to any broadcast of a weekday's evening news program, and there will be a segment that highlights the ups and downs of the Dow Jones Industrial Average and the Standard and Poor's (S&P) 500. These market measures provide an insight into what is going on in Wall Street. However, they are clearly biased to not only large firms but also huge firms. This creates the false notion that "real" business is only about big business. It fails to recognize that small businesses are the overwhelming majority of all businesses in America; not only are the majority of jobs in small businesses, but small businesses have also been the major driving force in new job creation and innovation. Small business is *the* dynamo of innovation in our economy. In 2006, Thomas M. Sullivan, the chief counsel for advocacy of the Small Business Administration (SBA), said, "Small business is a major part of our economy,...small businesses innovate and create new jobs at a faster rate than their larger competitors. They are nimble, creative, and a vital part of every community across the country." "Small Business by the Numbers," *National Small Business Administration*, accessed October 7, 2011, [www.nsba.biz/docs/bythenumbers.pdf](http://www.nsba.biz/docs/bythenumbers.pdf).

This text is devoted to small business, not entrepreneurship. There has always been a challenge to distinguish—correctly—between the small business owner and the entrepreneur. Some argue that there is no difference between the two terms. The word *entrepreneur* is derived from a French word for "to undertake," which might indicate that entrepreneurs should be identified as those who start businesses. "A Definition of Entrepreneurship," *QuickMBA.com*, accessed October 7, 2011, [www.quickmba.com/entre/definition](http://www.quickmba.com/entre/definition). However, this interpretation is too broad and is pointless as a means of distinguishing between the two. Some have tried to find differences based on background, education, or age. Nick Leiber, "The Anatomy of an Entrepreneur," *Bloomberg BusinessWeek*, July 8, 2009, accessed October 7, 2011, [www.BusinessWeek.com/smallbiz/running\\_small\\_business/archives/2009/07/anatomy\\_of\\_an\\_e.html](http://www.BusinessWeek.com/smallbiz/running_small_business/archives/2009/07/anatomy_of_an_e.html). Often one finds the argument that entrepreneurs have a different orientation toward risk than small business owners. The standard line is that entrepreneurs are willing to take great risks in starting an enterprise and/or willing to start again after a business failure. "Entrepreneur vs. Small Business Owner: What's the Difference?," *Mills Communication Group*, July 22, 2009, accessed October 7, 2011, [www.millscommgroup.com/blog/2009/06/entrepreneur-vs-small-business-owner-whats-the-difference](http://www.millscommgroup.com/blog/2009/06/entrepreneur-vs-small-business-owner-whats-the-difference). Others try to make the distinction based on the issue of innovation or the degree of innovation. Given this focus, entrepreneurs need not even work for small business because they can come up with innovative products, services, production, or marketing processes in large organizations. Dale Beermann, "Entrepreneur or Small Business Owner? Does It Matter?," *Brazen Careerist*, January 30, 2009, accessed October 7, 2011, [www.brazencareerist.com/2009/01/29/entrepreneur-or-small-business-owner-does-it-matter](http://www.brazencareerist.com/2009/01/29/entrepreneur-or-small-business-owner-does-it-matter). Perhaps the most common interpretation of the entrepreneur is an individual involved in a high-tech start-up who becomes a billionaire. That is not the focus of this text. It centers on the true driving force of America's economy—the small business.

This chapter gives a brief history of small business in the United States, the critical importance of small business to the American economy, the challenges facing small business owners as they struggle to survive and prosper, the requisite skills to be an effective small business owner, the critical importance of ethical behavior, and how these businesses may evolve over time. In addition, three critical success factors for the twenty-first-century small business are threaded through the text: (1) *identifying and providing customer value*, (2) *being able to exploit digital technologies with an emphasis on e-business and e-commerce*, and (3) *properly managing your cash flow*. These three threads are essential to the successful decision making of any contemporary small business and should be considered of paramount importance. They are everyday considerations.

### A Brief History of Small Business

Throughout American history, from colonial times until today, most businesses were small businesses, and they have played a vital role in America's economic success and are a forge to our national identity. It would not be an exaggeration to say that the small businessperson has always held an important—even exalted—position in American life. Americans in the early republic were as

suspicious of large economic enterprises as threats to their liberty as they were of large government. The historian James L. Houston discussed American suspicion of large economic enterprises: “Americans believed that if property was concentrated in the hands of a few in the republic, those few would use their wealth to control other citizens, seize political power, and warp the republic into an oligopoly.” Jack Beatty, *The Age of Betrayal: The Triumph of Money in America 1865–1900* (New York: Alfred A. Knopf, 2007), 11. In fact, much of the impetus behind the Boston Tea Party was the fear on the part of local merchants and tradesmen that the East India Company, at that time the world’s largest corporation, was dumping low-priced tea in the colonies, which would have driven local business to ruin. Ted Nace, *The Gangs of America: The Rise of Corporate Power and the Disabling of Democracy* (San Francisco: Berrett-Koehler Publishers, 2003), 44. Jefferson’s promotion of the yeoman farmer, which included small merchants, as the bulwark of democracy stemmed from his fear of large moneyed interests: “The end of democracy and the defeat of the American Revolution will occur when government falls into the hands of lending institutions and moneyed incorporations.” Bob Higgins, “Like Lincoln, Jefferson, Madison—Americans Fear Corporate Control of Public Policy,” *TPMCafe*, February 17, 2011, accessed October 23, 2011, [tpmcafe.talkingpointsmemo.com/talk/blogs/r/l/r/h/974/2010/02/like-lincoln-jefferson-madison.php](http://tpmcafe.talkingpointsmemo.com/talk/blogs/r/l/r/h/974/2010/02/like-lincoln-jefferson-madison.php). So great was the fear of the large aggregation of wealth that the colonies and the early republic placed severe restrictions on the creation of corporate forms. In the first decades of the nineteenth century, state governments restricted the corporate form by limiting its duration, geographic scope, size, and even profits. Ted Nace, *The Gangs of America: The Rise of Corporate Power and the Disabling of Democracy* (San Francisco: Berrett-Koehler Publishers, 2003), 44. This was done because of the concern that corporations had the potential of becoming monopolies that would drive entrepreneurs out of business.

Eventually, however, some businesses grew in size and power. Their growth and size necessitated the development of a professional management class that was distinct from entrepreneurs who started and ran their own businesses. However, not until the post–Civil War period did America see the true explosion in big businesses. This was brought about by several factors: the development of the mass market (facilitated by the railroads); increased capital requirement for mass production; and the 1886 Supreme Court case of *Santa Clara County v. Southern Pacific Railroad*, which granted corporations “personhood” by giving them protection under the Fourteenth Amendment.

The growth of corporations evoked several responses that were designed to protect small businesses from their larger competitors. The Interstate Commerce Act (1887) was a federal law designed to regulate the rates charged by railroads to protect small farmers and businesses. Other federal laws—the Sherman Act (1890) and the Clayton Act (1914)—were passed with the initial intent of restricting the unfair trading practices of trusts. In the early years, however, the Sherman Act was used more frequently against small business alliances and unions than against large businesses. Congress continued to support small businesses through the passage of legislation. The Robinson-Patman Act of 1936 and the Miller-Tydings Act of 1937 were designed to protect small retailers from large chain retailers. Mansel Blackford, *The History of Small Business in America*, 2nd ed. (Chapel Hill, NC: University of North Carolina Press, 2003), 4.

The Depression and the post–World War II environments posed special challenges to small business operations. The Hoover and Roosevelt administrations created organizations (the Reconstruction Finance Corporation in 1932 and the Small War Plants Corporation in 1942) to assist small firms. The functions of several government agencies were subsumed into the **Small Business Administration** in 1953. The designated purpose of the SBA was to “aid, counsel, assist and protect, insofar as is possible, the interests of small business concerns.” “What We Do,” *Small Business Administration*, accessed October 7, 2011, [www.sba.gov/about-sba-services/what-we-do](http://www.sba.gov/about-sba-services/what-we-do). The SBA functions to ensure that small businesses have a fair chance at securing government contracts. It also has the responsibility of defining what constitutes a small business.

If anything is to be learned from the passage of all this legislation, it is that, as Conte (2006) eloquently put it, “Americans continued to revere small businesspeople for their self-reliance and independence.” Christopher Conte, “Small Business in U.S. History,” *America.gov*, January 3, 2006, accessed October 7, 2011, [www.america.gov/st/business-english/2008/July/20080814215602XJyreP0.6187664.html](http://www.america.gov/st/business-english/2008/July/20080814215602XJyreP0.6187664.html).

## Definition of Small Business

The SBA definition of a small business has evolved over time and is dependent on the particular industry. In the 1950s, the SBA defined a **small business** firm as “independently owned and operated...and not dominant in its field of operation.” Mansel Blackford, *The History of Small Business in America*, 2nd ed. (Chapel Hill, NC: University of North Carolina Press, 2003), 4. This is still part of their definition. At that time, the SBA classified a small firm as being limited to 250 employees for industrial organizations. Currently, this definition depends on the North American Industry Classification System (NAICS) for a business. The SBA recognizes that there are significant differences, across industries, with respect to competitiveness, entry and exit costs, distribution by size, growth rates, and technological change. Although the SBA defines 500 employees as the limit for the majority

of industrial firms and receipts of \$7 million for the majority of service, retail, and construction firms, there are different values for some industries. Table 1.1 presents a selection of different industries and their size limits.

Table 1.2.1: Examples of Size Limits for Small Businesses by the SBA

NAICS Code	NAICS US Industry Title	Size Standards (Millions of \$)	Size Standards (Number of Employees)
111333	Strawberry farming	0.75	
113310	Timber tract operations	7.00	
114112	Shellfish fishing	4.00	
212210	Iron ore mining		500
236115	New single family housing construction	33.50	
311230	Breakfast cereal manufacturer		1,000
315991	Hat, cap, and millenary manufacturing		500
443111	Household appliance store	9.00	
454311	Heating oil dealers		50
483111	Deep sea freight transportation		500
484110	General freight trucking, local	25.50	
511130	Book publishers		500
512230	Music publishers		500
541214	Payroll services	8.50	
541362	Geophysical surveying and mapping services	4.50	
541712	Research and development in physical, engineering, and life sciences		500
	<i>Except aircraft</i>		1,500
722110	Full-service restaurants	7.00	
722310	Food service contractors	20.50	
811111	General automotive repair	7.00	
812320	Dry cleaning and laundry services	4.50	
813910	Business associations	7.00	

Source: "Table of Small Business Size Standards Matched to North American Industry Classification System Codes," *US Small Business Administration*, August 22, 2008, accessed June 1, 2012, <http://www.sba.gov/content/small-business-size-standards>

The SBA definition of what constitutes a small business has practical significance. Small businesses have access to an extensive support network provided by the SBA. It runs the SCORE program, which has more than 12,000 volunteers who assist small firms with counseling and training. The SBA also operates Small Business Development Centers, Export Assistance Centers, and Women's Business Centers. These centers provide comprehensive assistance to small firms. There can be significant economic support for small firms from the SBA. It offers a variety of guaranteed loan programs to start-ups and small firms. It assists small

firms in acquiring access to nearly half a trillion dollars in federal contracts. In fact, legislation attempts to target 23 percent of this value for small firms. The SBA can also assist with financial aid following a disaster.

## Small Business in the American Economy

In 1958, small business contributed 57 percent of the nation's gross domestic product (GDP). This value dropped to 50 percent by 1980. What is remarkable is that this 50 percent figure has essentially held steady for the last thirty years. Katherine Kobe, "The Small Business Share of GDP, 1998–2004," *Small Business Research Summary*, April 2007, accessed October 7, 2011, [archive.sba.gov/advo/research/rs299tot.pdf](http://archive.sba.gov/advo/research/rs299tot.pdf). It is interesting to note that the contribution of small businesses to the GDP can vary considerably based on particular industries. Table 1.2 presents data for selected industries for the period 1998–2004. It can be seen that in some industries—construction and real estate—80 percent or more of that industry's contribution to the GDP comes from small businesses, while in the information industry that number is 20 percent or less.

Few people realize that the overwhelming majority of businesses in the United States are small businesses with fewer than five hundred employees. The SBA puts the number of small businesses at 99.7 percent of the total number of businesses in the United States. However, most of the businesses are nonemployee businesses (i.e., no paid employees) and are home based.

Table 1.2.2: Small Businesses' Component of Industry Contribution to GDP

Year	Construction (%)	Real Estate and Leasing (%)	Wholesale Trade (%)	Transportation and Warehousing (%)	Information (%)
1998	88.0	80.4	59.1	39.1	26.4
1999	87.2	80.0	57.5	39.4	25.4
2000	85.4	79.8	56.8	39.0	22.7
2001	85.1	80.3	55.3	41.1	19.7
2002	84.6	79.4	56.3	41.0	20.3
2003	85.4	79.5	54.6	39.1	20.3
2004	85.6	79.6	55.4	38.6	18.0

Source: Katherine Kobe, "Small Business Share of GDP (Contract No. SBAHQ-05-M-0413)," *SBA Office of Advocacy*, April 2007, accessed October 7, 2011, [archive.sba.gov/advo/research/rs299tot.pdf](http://archive.sba.gov/advo/research/rs299tot.pdf).

One area where the public has a better understanding of the strength of small business is in the area of innovation. Evidence dating back to the 1970s indicates that small businesses disproportionately produce innovations. Zoltan J. Acs and David B. Audretsch, "Innovation in Large and Small Firms: An Empirical Analysis," *American Economic Review* 78, no. 4 (1988): 678–90. It has been estimated that 40 percent of America's scientific and engineering talent is employed by small businesses. The same study found that small businesses that pursue patents produce thirteen to fourteen times as many patents per employee as their larger counterparts. Further, it has been found that these patents are twice as likely to be in the top 1 percent of highest impact patents. "Small Business by the Numbers," *National Small Business Administration*, accessed October 7, 2011, [www.nsba.biz/docs/bythenumbers.pdf](http://www.nsba.biz/docs/bythenumbers.pdf).

It is possible that small size might pose an advantage with respect to being more innovative. The reasons for this have been attributed to several factors:

- **Passion.** Small-business owners are interested in making businesses successful and are more open to new concepts and ideas to achieve that end.
- **Customer connection.** Being small, these firms better know their customers' needs and therefore are better positioned to meet them.
- **Agility.** Being small, these firms can adapt more readily to changing environment.
- **Willingness to experiment.** Small-business owners are willing to risk failure on some experiments.
- **Resource limitation.** Having fewer resources, small businesses become adept at doing more with less.
- **Information sharing.** Smaller size may mean that there is a tighter social network for sharing ideas. Jeff Cornwall, "Innovation in Small Business," *The Entrepreneurial Mind*, March 16, 2009, accessed June 1, 2012, [http://www.drjeffcornwall.com/2009/03/16/innovation\\_in\\_small\\_business/](http://www.drjeffcornwall.com/2009/03/16/innovation_in_small_business/).

Regardless of the reasons, small businesses, particularly in high-tech industries, play a critical role in preserving American global competitiveness.

## Small Business and National Employment

The majority—approximately 50.2 percent in 2006—of private sector employees work for small businesses. A breakdown of the percentage of private sector employees by firm size for the period 1988 to 2006 is provided in Table 1.3. For 2006, slightly more than 18 percent of the entire private sector workforce was employed by firms with fewer than twenty employees. It is interesting to note that there can be significant difference in the percentage of employment by small business across states. Although the national average was 50.2 percent in 2006, the state with the lowest percentage working for small businesses was Florida with 44.0 percent, while the state with the highest percentage was Montana with a remarkable 69.8 percent. “Small Business by the Numbers,” *National Small Business Administration*, accessed October 7, 2011, [www.nsba.biz/docs/bythenumbers.pdf](http://www.nsba.biz/docs/bythenumbers.pdf).

Table 1.2.3: Percentage of Private Sector Employees by Firm Size

Year	0–4 Employees	5–9 Employees	10–19 Employees	20–99 Employees	100–499 Employees	500+ Employees
1988	5.70%	6.90%	8.26%	19.16%	14.53%	45.45%
1991	5.58%	6.69%	8.00%	18.58%	14.24%	46.91%
1994	5.50%	6.55%	7.80%	18.29%	14.60%	47.26%
1997	5.20%	4.95%	6.36%	16.23%	13.73%	53.54%
2000	4.90%	5.88%	7.26%	17.78%	14.26%	49.92%
2003	5.09%	5.94%	7.35%	17.80%	14.49%	49.34%
2006	4.97%	5.82%	7.24%	17.58%	14.62%	49.78%

Source: US Census Bureau, “Statistics of U.S. Business,” accessed October 7, 2011, [www.census.gov/econ/susb](http://www.census.gov/econ/susb).

Small business is the great generator of jobs. Recent data indicate that small businesses produced 64 percent of the net new jobs from 1993 to the third quarter of 2008. “Statistics of U.S. Businesses,” *US Census Bureau*, April 13, 2010, accessed October 7, 2011, [www.census.gov/econ/susb](http://www.census.gov/econ/susb). This is not a recent phenomenon. Thirty years of research studies have consistently indicated that the driving force in fostering new job creation is the birth of new companies and the net additions coming from small businesses. In the 1990s, firms with fewer than twenty employees produced far more net jobs proportionally to their size, and two to three times as many jobs were created through new business formation than through job expansion in small businesses. William J. Dennis Jr., Bruce D. Phillips, and Edward Starr, “Small Business Job Creation: The Findings and Their Critics,” *Business Economics* 29, no. 3 (1994): 23–30. The US Census Bureau’s Business Dynamics Statistics data confirm that the greatest number of new jobs comes from the creation of new businesses. One can get a sense of the extent of net job change by business size in Table 1.4.

An additional point needs to be made about job creation and loss by small businesses in the context of overall economic conditions. Government data show that of the “net 1.5 million jobs lost in 2008, 64 percent were from small firms.” Brian Headd, “An Analysis of Small Business and Jobs,” *Small Business Administration*, March 2010, accessed October 7, 2011, [www.sba.gov/advo/research/rs359tot.pdf](http://www.sba.gov/advo/research/rs359tot.pdf) (p. 10). However, the same study had some interesting results from the past two recessions. In the 2001 recession, small businesses with fewer than 20 employees experienced 7 percent of the total reduction in jobs, firms with between 20 and 500 employees were responsible for 43 percent of the job losses, and the rest of the job losses came from large firms. As the economy recovered in the following year, firms with fewer than 20 employees created jobs, while the other two groups continued to shed jobs. Following the 1991 recession, it was firms with 20 to 500 employees that were responsible for more than 56 percent of the jobs that were added.

Table 1.2.4: Job Creation by Firm Size

Years	1–4	5–9	10–19	20–99	100–499	500+
2002–2003	1,106,977	307,690	158,795	304,162	112,702	(994,667)
2003–2004	1,087,128	336,236	201,247	199,298	66,209	(214,233)

Years	1–4	5–9	10–19	20–99	100–499	500+
2004–2005	897,296	141,057	(11,959)	(131,095)	83,803	262,326
2005–2006	1,001,960	295,521	292,065	590,139	345,925	1,072,710

Source: “Small Business Profile,” *SBA Office of Advocacy*, 2009, [archive.sba.gov/advo/research/data.html](http://archive.sba.gov/advo/research/data.html).

One last area concerning the small business contribution to American employment is its role with respect to minority ownership and employment. During the last decade, there has been a remarkable increase in the number of self-employed individuals. From 2000 to 2007, the number of women who were self-employed increased by 9.7 percent. The number of African Americans who were self-employed increased by 36.6 percent for the same time range. However, the most remarkable number was an increase of nearly 110 percent for Hispanics. It is clear that small business has become an increasingly attractive option for minority groups. “Statistics of U.S. Businesses,” *US Census Bureau*, April 13, 2010, accessed October 7, 2011, [www.census.gov/econ/susb/](http://www.census.gov/econ/susb/). Women and Hispanics are also employed by small businesses at a higher rate than the national average.

#### KEY TAKEAWAYS

- Small businesses have always played a key role in the US economy.
- Small businesses are responsible for more than half the employment in the United States.
- Small businesses have a prominent role in innovation and minority employment.

#### EXERCISES

1. Throughout this text, you will be given several assignments. It would be useful if these assignments had some degree of consistency. Select a type of business that interests you and plan on using it throughout some of the chapter assignments. After selecting your business, go to [www.sba.gov/content/table-small-business-size-standards](http://www.sba.gov/content/table-small-business-size-standards) and determine the size of the business.
2. In the United States, 50 percent of those employed are working for small businesses. There are considerable differences across states. Go to [www.census.gov/econ/susb/](http://www.census.gov/econ/susb/) and compute the percentage for your state. What factors might account for the differences across states?

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