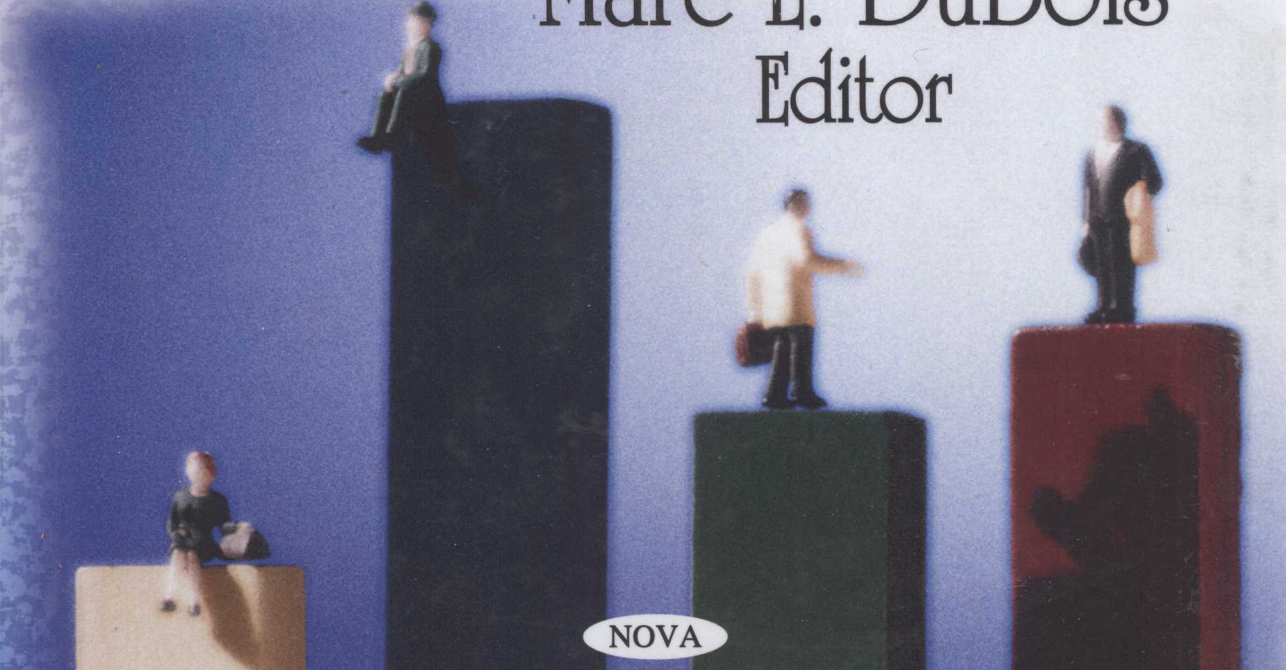
Business Issues, Competition and Entrepreneurship

Small Business

Economic and Development Issues

Marc L. DuBois
Editor



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BUSINESS ISSUES, COMPETITION, AND ENTREPRENEURSHIP

SMALL BUSINESS: ECONOMIC AND DEVELOPMENT ISSUES

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PREFACE

Small business size standards are of congressional interest because the definition used determines eligibility for Small Business Administration (SBA) loans and consultative support assistance as well as federal contracting preferences and federal tax preferences. Although there is bipartisan agreement that the nation's small businesses play a key role in the American economy, there are differences of opinion concerning how to define them. The Small Business Act of 1953 authorized the Small Business Administration and made it responsible for establishing size standards for determining eligibility for federal small business assistance. This book provides an historical examination of the SBA's size standards, small business access to capital and job creation, tighter credit standings and small business employment, 7(a) Loan Guaranty Program, SBA Microloan program, and health care reform and small business

Chapter 1- Small business size standards are of congressional interest because the definition used determines eligibility for Small Business Administration (SBA) loans and consultative support assistance as well as federal contracting preferences and federal tax preferences.

Although there is bipartisan agreement that the nation’s small businesses play a key role in the American economy, there are differences of opinion concerning how to define them. The Small Business Act of 1953 (P.L. 83-163, as amended) authorized the Small Business Administration and made it responsible for establishing size standards for determining eligibility for federal small business assistance. The SBA currently uses one of the following four criteria to determine program eligibility for firms in 1,159 industrial classifications described in the North American Industry Classification System (NAICS): (1) number of employees; (2) average annual receipts in the previous three years; (3) asset size; or (4) for electrical power industries, the extent of power generation. Overall, the SBA currently classifies about 9 9.7% of all employer firms as small.

Chapter 2 The Small Business Administration’s (SBA) authorization is due to expire on July 31, 2010- The SBA administers several programs to support small businesses, including loan guarantees to assist small businesses gain access to capital. This report addresses a core issue facing Congress during the SBA’s reauthorization process: what, if any, additional action should the federal government take to enhance small business access to capital?

Historically, small businesses (firms with less than 500 employees) have experienced greater job loss during economic recessions than larger businesses. Conversely, small businesses have led job creation during recent economic recoveries. As a result, many federal policymakers look to small businesses to lead the nation's recovery from its current economic difficulties. Some, including the chairs of the House and Senate Committees on Small Business and President Obama, have argued that current economic conditions make it imperative that the SBA be provided additional resources to assist small businesses in acquiring capital necessary to start, continue, or expand operations and create jobs. Others worry about the long-term adverse economic effects of spending programs that increase the federal deficit. They advocate business tax reduction, reform of financial credit market regulation, and federal fiscal restraint as the best means to assist small business economic growth and job creation.

Chapter 3- Small and large firms have differing roles in the labor market. Relatively new data now allow us to better dissect the labor market with respect to job flows (hires, fires, retires, and job hoppers) and firm size and even in some instances firm age. Understanding who creates and destroys jobs is paramount as we seek a solution for our loss of over 7 million net jobs from December 2007 to December 2009.[1]

While small and large firms provide roughly equivalent shares of jobs, the major part of job generation and destruction takes place in the small firm sector, and small firms provide the greater share of net new jobs. In some ways this role as a major creator and destroyer of jobs is a result of being the major creator and destroyer of businesses in general. The term for this in small business research circles which was popularized by Joseph Schumpeter (1942) is "creative destruction."

Chapter 4- In recent testimony before the Joint Economic Committee, Dr. Alan Krueger, Assistant Secretary for Economic Policy and Chief Economist at the Treasury Department, highlighted the recent gap between hiring at large and small businesses, using previously unpublished Job Openings and Labor Turnover Survey data (JOLTS) from the Bureau of Labor Statistics. This report analyzes that same JOLTS data, which was made exclusively available to the U.S. Congress Joint Economic Committee, to better understand small business hiring between January 2001 and March 2010. Small business hiring remains well below its 2001-2007 average level. Since mid-2009, hiring among small businesses has continued to trend down, even as hiring by larger firms has increased.

The charts that follow make clear that small business lending remains tight and that small business hiring is well below that of larger firms and well below its average level over the past decade. Additional actions are needed to spur lending to small businesses and to help small businesses fully participate in the recovery that is now underway.

Chapter 5- The Small Business Administration (SBA) administers several programs to support small businesses, including loan guaranty programs designed to encourage lenders to provide loans to small businesses "that might not otherwise obtain financing on reasonable terms and conditions." The SBA's 7(a) loan guaranty program is considered the agency's flagship loan guaranty program. It is named from section 7(a) of the Small Business Act of 1953 (P.L. 83-163, as amended), which authorized the SBA to provide business loans and loan guaranties to American small businesses. In FY2009, the program guaranteed 38,307 loans amounting to about $9.2 billion.

Chapter 6- The Small Business Administration's (SBA) Microloan program provides direct loans to qualified non-profit intermediary Microloan lenders who, in turn, provide "microloans" of up to $35,000 to small business owners, entrepreneurs, and non-profit child care centers. It also provides marketing, management, and technical assistance to Microloan borrowers and potential borrowers. The program was authorized in 1991 as a five-year demonstration project and became operational in 1992. It was made permanent, subject to reauthorization, in 1997.

The SBA's Microloan program is designed to assist women, low-income, veteran, and minority entrepreneurs and small business owners and other individuals possessing the capability to operate successful business concerns by providing them small-scale loans for working capital or the acquisition of materials, supplies, or equipment.

Chapter 7- Some lawmakers have expressed concern over several proposals being considered in the current Congress to raise the tax burden on high-income individuals. Of particular concern are a proposal by the Obama Administration to allow the top two individual marginal tax rates (currently 33% and 35%) to return to their pre-2001 levels of 36% and 3 9.6%, starting in 2011, and a provision in the health care reform bill passed by the House (H.R. 3962) to impose a 5.4% surtax on the modified adjusted gross incomes (MAGIs) of single filers above $500,000 and the MAGIs of joint filers above $1 million, also starting in 2011. Critics claim the proposed tax hikes would undermine the economic incentives for small business formation and investment.

Chapter 8- This report discusses what constitutes a "disadvantaged" small business for purposes of federal and federally funded contracting programs and how firms are certified or otherwise designated as such. Three primary categories of disadvantaged small businesses are currently eligible for various contracting programs: (1) small businesses participating in the Small Business Administration's (SBA's) 8(a) Program (8(a) participants); (2) "small disadvantaged businesses" (SDBs) and (3) "disadvantaged business enterprises" (DBEs). These firms are characterized as "disadvantaged" because they are at least 51% unconditionally owned and controlled by socially and economically disadvantaged individuals or groups. Members of certain racial and ethnic groups are presumed to be disadvantaged, and other individuals can prove personal disadvantage by a preponderance of the evidence. Veterans and persons with disabilities are not presumed to be disadvantaged for purposes of these programs. However, there are separate contracting programs for them. Disadvantaged groups include Indian tribes, Alaska Native Corporations, Native Hawaiian Organizations, and Community Development Corporations. In FY2008, the federal government awarded $29.3 billion in contacts or subcontracts to SDBs, including $6.3 billion in contracts to 8(a) participants. Comparable data regarding contracting with DBEs are not readily available.

Chapter 9- An issue in the development of the new health care reform legislation is the effect on small business. One concern is the effect of a "pay or play" mandate to require firms to provide health insurance for their employees or pay a penalty. Current proposals have exemptions for small businesses, and also propose to provide subsidies for purchasing insurance. Economic theory suggests that health insurance costs (and any penalties) should be passed on to labor income, but that may be more difficult for employers of lower-wage workers. Furthermore, average wages are generally smaller for small firms (except for the smallest). A second concern is the potential effect of taxes on high-income individuals on small business.

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Chapter 1

DEFINING SMALL BUSINESS: AN HISTORICAL ANALYSIS OF CONTEMPORARY ISSUES

Robert Jay Dilger

SUMMARY

Small business size standards are of congressional interest because the definition used determines eligibility for Small Business Administration (SBA) loans and consultative support assistance as well as federal contracting preferences and federal tax preferences.

Although there is bipartisan agreement that the nation's small businesses play a key role in the American economy, there are differences of opinion concerning how to define them. The Small Business Act of 1953 (P.L. 83-163, as amended) authorized the Small Business Administration and made it responsible for establishing size standards for determining eligibility for federal small business assistance. The SBA currently uses one of the following four criteria to determine program eligibility for firms in 1,159 industrial classifications described in the North American Industry Classification System (NAICS): (1) number of employees; (2) average annual receipts in the previous three years; (3) asset size; or (4) for electrical power industries, the extent of power generation. Overall, the SBA currently classifies about 9 9.7% of all employer firms as small.

Since issuing its initial small business size standards in 1956, the SBA has based its industry size standards on economic analysis. However, in the absence of precise statutory guidance and consensus on how to define small, the SBA's size standards have often been challenged, typically by industry representatives advocating a broadening of the size standards to allow more firms in their industry to be eligible for assistance and by Members of Congress concerned that the size standards may not adequately target the SBA's assistance to firms that they consider to be truly small.

Congress is currently considering several bills that would authorize an alternative size standard as a means to allow more small businesses to meet the SBA's requirements to access SBA-backed loans. In the Senate, S. 3103, the Small Business Job Creation Act of 2010, S. 2869, the Small Business Job Creation and Access to Capital Act of 2009, and S.Amdt. 4407,

an amendment in the nature of a substitute for H.R. 5297, the Small Business Lending Fund Act of 2010, which is currently under consideration in the Senate, would authorize the SBA to establish an alternative size standard using maximum tangible net worth and average net income after federal taxes for both the 7(a) and 504/CDC loan guaranty programs.

In the House, H.R. 4302, the Small Business Job Creation and Access to Capital Act of 2009, was introduced as a companion bill for S. 2869, the Small Business Job Creation and Access to Capital Act of 2009. Also, H.R. 3854, the Small Business Financing and Investment Act of 2009, passed by the House on October 29, 2009, would authorize the SBA to establish an alternative size standard for the SBA's 7(a) loan guaranty program that is based on the business's maximum tangible net worth and average net income after taxes. Until that alternative size standard is established, the bill would authorize an interim alternative size standard for the 7(a) loan guaranty program that is based on the SBA's size standard for the 504/CDC loan guaranty program—a maximum tangible net worth not in excess of $8.5 million and average net income after federal taxes not in excess of $3 million for the preceding two completed fiscal years.

This report provides an historical examination of the SBA's size standards, competing views that have been presented concerning how to define a small business, and how various proposals for changing the SBA's size standards would affect program eligibility.

WHAT IS A SMALL BUSINESS?

There is bipartisan agreement that small businesses play a key role in the American economy. For example, the Senate Democratic Policy Committee asserts that "America's ... small businesses serve as the engine of the American economy."[1] The Senate Republican Policy Committee agrees, asserting that "Small businesses ... [are] the engines of growth in the American economy."[2] President Barack Obama concurs, stating that

> Small businesses are the heart of the American economy. They're responsible for half of all private sector jobs—and they created roughly 70 percent of all new jobs in the past decade. So small businesses are not only job generators, they're also at the heart of the American Dream. After all, these are businesses born in family meetings around kitchen tables. They're born when a worker takes a chance on her desire to be her own boss. They're born when a part-time inventor becomes a full-time entrepreneur, or when somebody sees a product that could be better or a service that could be smarter, and they think, "Well, why not me? Let me try it. Let me take my shot."[3]

Although there is a general consensus that small businesses are important to the economy, there are differences of opinion concerning how to define them. This issue is of congressional interest because the definition used determines business eligibility for Small Business Administration (SBA) loan and consultative support assistance as well as federal contracting preferences and federal tax preferences for small businesses.

Table 1. Number of Employer Firms, Employer Firm Employment, and Employer Firm Annual Payroll, by Employer Firm Employment Size, 2006

Number of Employees	Number of Employer Firms	Cumulative Percentage of Total Number of Employer Firms	Employment	Cumulative Percentage of Employer Firm Total Employment	Employer Firm Annual Payroll ($1,000)	Cumulative Percentage of Employer Firm Total Annual Payroll
0[a]	794,622	13.2%	-	-	$42,278,863	0.9%
1-4	2,875,935	61.0	5,959,585	5.0%	187,451,177	4.8
5-9	1,060,787	78.6	6,973,537	10.8	214,137,111	9.3
10 - 19	646,816	89.3	8,676,398	18.0	282,193,078	19.9
20-49	406,464	96.1	12,210,784	28.2	420,435,449	23.9
50-99	129,401	98.2	8,866,091	35.6	321,481,704	30.6
100-499	90,560	99.7	17,537,345	50.2	660,815,715	44.4
500-999	8,974	99.9	6,197,683	55.4	247,551,621	49.6
1,000-1,499	2,962	99.9	3,605,836	58.4	152,725,489	52.8
1,500-2,499	2,374	99.9	4,537,676	62.2	195,499,433	56.9
2,500-4,999	1,877	99.9	6,479,030	67.6	304,377,206	63.2
5,000-9,999	931	99.9	6,490,547	73.0	302,709,162	69.5
10,000+	953	100.0	32,382,653	100.0	1,460,773,903	100.0
Total	6,022,127		119,917,165		4,792,429,911	

Source: U.S. Small Business Administration, Office of Advocacy, "Employer Firms, Establishments, Employment, and Annual Payroll Small Firm Size Classes, 2006," Washington, DC, http://www.sba.gov/advo/research/ us_06ss.pdf.

a. Employment is measured in March, thus some employer firms (start-ups after March, closures before March, and seasonal firms) will have zero employment and some annual payroll.

HOW BIG IS SMALL?

The SBA estimates that there were 29.6 million businesses in the United States in 2008, including 6.1 million employer firms and 23.1 million nonemployer firms.[4] Nonemployer firms have no paid employees, annual business receipts of $1,000 or more ($1 or more in the construction industries), and are subject to federal income tax.[5] Most nonemployers are self-employed individuals operating very small unincorporated businesses, which may or may not be the owner's principal source of income. These firms are excluded from most business statistics.[6]

As **Table 1** indicates, in 2006 (the latest available data), there were 6,022,127 employer firms in the United States employing 119,917,165 people and providing total payroll of $4.79 trillion.

Most employer firms (61.0%) had fewer than 5 employees, 89.3% had fewer than 20 employees, 98.2% had fewer than 100 employees, and 99.7% had fewer than 500 employees. The table also provides data concerning three possible economic factors that might be used to define a small business: an employer firm's number of employees as a share (cumulative percentage) of the total number of employer firms, as a share of employer firm total employment, and as a share of employer firm total annual payroll.

As will be discussed, the SBA has traditionally applied economic factors to specific industries, not to cumulative statistics for all employer firms, to determine which firms are small businesses. Nonetheless, the data in **Table 1** illustrate how the selection of economic factors used to define small business affects the definition's outcome. For example, for illustrative purposes only, if the mid-point (50%) for these three economic factors was used to define what is a small business, three different employee firm sizes would be used to designate firms as small:

- Businesses would be required to have less than five employees to be defined as small if the definition for small used the mid-point (50%) share of the total number of employer firms (employer firms with less than five employees accounted for 61% of the total number of employer firms in 2006).
- Businesses would be required to have less than 500 employees to be defined as small if the definition for small used the mid-point (5 0%) share of employer firm total employment (employer firms with less than 500 employees accounted for 50.2% of employer firm total employment in 2006).
- Businesses would be required to have less than 1,500 employees to be defined as small if the definition for small used the mid-point (5 0%) share of employer firm total annual payroll (employer firms with less than 1,500 employees accounted for 52.8% of employer firm total annual payroll in 2006).

Other economic factors that might be used to define a small business include the value of the employer firm's assets or its market share, expressed as a firm's sales revenue from that market divided by the total sales revenue available in that market or as a firm's unit sales volume in that market divided by the total volume of units sold in that market.

WHO MAKES THE CALL?

The Small Business Act of 1953 (P.L. 83-163, as amended) authorized the SBA and made it responsible for establishing size standards for determining eligibility for small business assistance. More than 50 years have passed since the SBA established its initial small business size standards in 1956. Yet, decisions made then concerning the rationale and criteria used to define small businesses established precedents that continue to shape current policy. Moreover, as will be shown, since its beginnings the SBA has based its size standards on economic analysis. However, in the absence of precise statutory guidance and consensus on how to define small, the SBA's size standards have often been challenged, typically by industry representatives advocating a broadening of the size standards to allow more firms in their industry to be eligible for assistance and by Members of Congress concerned that the size standards do not adequately target the SBA's assistance to firms that they consider to be truly small.

Over the years, the SBA has typically reviewed its size standards piecemeal, reviewing specific industries when the SBA determined that an industry's market conditions had changed or the SBA was asked to undertake a review by an industry claiming that its market conditions had changed. On five occasions, in 1980, 1982, 1992, 2004, and 2008, the SBA proposed a comprehensive revision of its size standards. None of these proposals were fully implemented, but the arguments presented, both for and against the proposals, provide a context for understanding the SBA's current size standards, and the rationale and criteria that have been presented to retain and replace them.

EARLY DEFINITIONS OF SMALL BUSINESS VARY IN APPROACH AND CRITERIA

Today, there is no uniform or accepted definition for a small business. Instead, several criteria are used to determine eligibility for small business spending and tax programs.[7] This was also the case when Congress considered establishing the SBA during the early 1950s. For example, in 1952, the House Select Committee on Small Business reviewed federal statutes, executive branch directives, and the academic literature to serve as a guide for determining how to define small businesses.

The Select Committee began its review by asserting that the need to define the concept of small business was based on a general consensus that assisting small business was necessary to enhance economic competition, combat monopoly formation, inhibit the concentration of economic power, and maintain "the integrity of independent enterprise."[8] It noted that the definition of small businesses in federal statutes reflected this consensus by taking into consideration the firm's size relative to other firms in its field and "matters of independence and nondominance."[9] For example, the War Mobilization and Reconversion Act of 1944 defined a small business as either "employing 250 wage earners or less" or having "sales volumes, quantities of materials consumed, capital investments, or any other criteria which are reasonably attributable to small plants rather than medium- or large-sized plants."[10] The Selective Service Act of 1948 classified a business as small for military procurement purposes if "(1) its position in the trade or industry of which it is a part is not dominant, (2) the number of its employees does not exceed 500, and (3) it is independently owned and operated."[11]

The Select Committee also found that, for data-gathering purposes, the executive branch defined small businesses in relative, as opposed to absolute, terms within specific industries. For example, the Bureau of Labor Statistics "defined small business in terms of an average for each industry based on the volume of employment or sales. All firms which fall below this average are deemed to be small."[12] The Bureau of the Census also used different criteria for different industries. For example, manufacturing firms were classified as small if they had fewer than 100 employees, wholesalers were considered small if they had annual sales below $200,000, and retailers were considered small if they had annual sales below $50,000. According the Bureau of the Census, in 1952, small businesses accounted for "roughly 92 percent of all business establishments, 45 percent of all employees, and 34 percent of all dollar value of all sales."[13]

The Select Committee also noted that in 1951, the National Production Authority's Office of Small Business proposed defining all manufacturing firms with less than 50 employees as small and any with more than 2,500 employees as large. Manufacturers employing between these numbers of employees would be considered large or small depending on the general structure of the industry to which they belonged. The larger the percentage of total output produced by large firms, the larger the number of employees a firm could have to be considered small. Using this definition, most manufacturing firms with less than 50 employees would be classified as small, but others, such as an aircraft manufacturer, could have as many as 2,500 employees and still be considered small.[14]

For procurement purposes, the Select Committee found that executive branch agencies defined small businesses in absolute, as opposed to relative, terms, using 500 employees as the dividing line between large and small firms. Federal agencies defended the so-called 500 employee rule on the grounds that it "had the advantage of easy administration" across federal agencies.[15]

In reviewing the academic literature, the Select Committee reported that Abraham Kaplan's *Small Business: Its Place and Problems* defined small businesses as those with no more than $1 million in annual sales, $100,000 in total assets, and no more than 250 employees. Applying this definition would have classified about 95% of all business concerns as small, and would have accounted for about half of all nonagricultural employees.[16]

Based on its review of federal statutes, executive branch directives, and the academic literature, the Select Committee decided that it would not attempt "to formulate a rigid definition of small business" because "the concept of small business must remain flexible and adaptable to the peculiar needs of each instance in which a definition may be required."[17] However, it concluded that the definition of *small* should be a relative one, as opposed to an absolute one, that took into consideration variations among economic sectors:

> This committee is also convinced that whatever limits may be established to the category of small business, they must vary from industry to industry according to the general industrial pattern of each. Public policy may demand similar treatment for a firm of 2,500 employees in one industry as it does for a firm of 50 employees in another industry. Each may be faced with the same basic problems of economic survival.[18]

THE SMALL BUSINESS ACT OF 1953'S DEFINITION OF SMALL PROVIDES ROOM FOR INTERPRETATION

Reflecting the view that formulating a rigid definition of small business was impractical, the Small Business Act of 1953 provided leeway in defining small businesses. It defined a small firm as "one that is independently owned and operated and which is not dominant in its field of operation."[19] The SBA was provided authority to establish and subsequently alter size standards for determining eligibility for federal programs to assist small business, some of which are administered by the SBA.[20] The act specifies that the size standards "may utilize number of employees, dollar volume of business, net worth, net income, a combination thereof, or other appropriate factors."[21] It also notes that the concept of small is to be defined in a relative sense, varying from industry to industry to the extent necessary to reflect "differing characteristics" among industries.[22]

The House Committee on Banking and Currency's report accompanying H.R. 5141, the Small Business Act of 1953, issued on May 28, 1953, provided the committee's rationale for not providing a detailed definition of small: "It would be impractical to include in the act a detailed definition of small business because of the variation between business groups. It is for this reason that the act authorizes the Administration to determine within any industry the concerns which are to be designated small-business concerns for the purposes of the act."23 The report did not provide specific guidance concerning what the committee might consider to be small, but it did indicate that data on industry employment, as of March 31, 1948, "reveals that on the basis of employment, small business truly is small in size. Of the approximately 4 million business concerns, 87.4% had under 8 employees and 95.2% of the total number of concerns, employed less than 20 people."[24]

INDUSTRY CHALLENGES THE SBA'S INITIAL SIZE STANDARDS, CLAIMING THEY ARE TOO RESTRICTIVE

Initially, the SBA created two sets of size standards, one for federal procurement preference and set-aside programs and another for the SBA's loan and consultative support services. At the request of federal agencies, the SBA adopted the then-prevailing small business size standard used by federal agencies for procurement, which was 500 or fewer employees. The SBA retained the right to make exceptions to the 500 or fewer employee procurement size standard if the SBA determined that a firm having more than 500 employees was not dominant in its industry.

For the SBA's loan and consultative support services, the SBA's staff reviewed economic data provided by the Bureau of the Census to arrive at what Wendell Barnes, SBA's administrator, described at a congressional hearing in 1956 as "a fairly accurate conclusion as to what comprises small business in each industry."[25] Jules Abels, SBA's economic advisor to the administrator, explained at that congressional hearing how the SBA's staff determined what constituted a small business: