imprimis

Hillsdale College Hillsdale, Michigan 49242 Vol. 13, No. 9
September, 1984

AMERICAN SMALL BUSINESS: THE QUIET GIANT

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The dimensions of American small business are enormous. Almost four million small enterprises employ people; self-employment is the principal source of livelihood for about eight million; and over 16½ million are engaged in some type of recorded independent business activity. More than half our private workforce is employed by small business.

The value of the goods and services it produces makes American small business—alone—the world's fourth greatest economic power. Only the United States as a whole, Soviet Russia, and Japan produce more; West Germany's gross product follows directly.

Yet John Kenneth Galbraith has referred to small and independent business as an "anacronism." It is that description and ones like it which raise the most serious question for small-business proponents such as myself.

Will small business become the economic dinosaur of the rapidly approaching twenty-first century? Or does it make unique contributions that will allow small enterprise to stand on its own into the foreseeable future?

The great economic attribute of small business is said to be its entrepreneurial bent. Obviously, not all small businesses are entrepreneurial—at least by most definitions of "entrepreneur"—and not all the activity of larger firms is non-entrepreneurial. Bell Labs and its development of the transistor is an example of the latter. But I intend to approach the discussion from the perspective that small firms tend to be entrepreneurial and large firms tend to be managerial—and the two are at opposite ends of a continuum.

Entrepreneurship and entrepreneurial change are often couched in terms of technological innovation. The small firm which develops and markets a new widget is considered to be "entrepreneurial." The precise contribution of small business and independent inventors to technological change defies an answer. From the quantitative standpoint, however, a variety of studies indicate that small firms and individual inventors produced anywhere from twenty percent to one hundred percent of the important innovations; the fifty percent range was the most common result. Typical is a study conducted in 1982 among 246 award-winning innovations in food processing and manufacturing industries which concluded that forty-five percent of these innovations could be attributed to small firms.

From the qualitative standpoint, however, there is support for the thesis that small firms provide the truly big breakthroughs.

The following major small-business innovations are only a small portion of a list containing some very familiar products: air-conditioning, airplane, catalytic petroleum cracking, continuous casting, gyrocompass, insulin, laser, optical scanner, pacemaker, personal computer, turbojet engine, and xerography.

Imprimis is the journal of Hillsdale's two outreach programs seeking to foster clear thinking on the problems of our time: the Center for Constructive Alternatives in Michigan and the Shavano Institute for National Leadership in Colorado. Established 1972; current circulation, 105,000 worldwide. A subscription is free on request.

Besides the frequency and importance of small-business technological innovations, small firms appear to produce them using fewer financial resources and fewer people—and bring those products to market more rapidly. A recent study conducted for the Small Business Administration found that small firms produced two and one-half times more innovations per employee than did large firms; they also brought them to market in only two-thirds the amount of time. Further, small businesses have usually done so without the benefits and/or liabilities of government financial support. Only six percent of the $16 billion spent by the federal government on R&D in a recent year was directed to small firms. The Small Business Innovation Development Act will change that, hopefully to the benefit of small entrepreneurs and the nation as a whole.

Innovation in organizational methods has an impact on productivity and growth just as does technological change, and here too small business is deeply involved.

Henry Ford and Ray Kroc provide two obvious examples. And if imitation is the highest form of flattery, then it should be noted that large firms are increasingly shifting their focus to smaller, more personalized and possibly more entrepreneurial structures.

Israel Kirzner of New York University, another speaker at this same CCA Seminar, views entrepreneurial activity as fundamentally creating disequilibrium. No pun intended—entrepreneurs are, therefore, to be considered movers and shakers—non-conformists, if you will. They continually punch holes in the existing status-quo creating vacuums which must be filled. When xerography was developed, for example, large gaps were blown in the existing way of doing things. Carbon copies were out, broader dissemination of information was in. But from a slightly different vantage point, an *entrepreneurial event*, *i.e.*, a more efficient use of resources, can create equilibrium through the filling of gaps or holes in the market.

Being entrepreneurial, small business fills market gaps and fills them rapidly.

Small business is highly flexible and adaptive—not necessarily as individual firms, but as an aggregate entity. The gaps which are filled by small firms include the following: 1) highly specialized markets or markets with limited demand, 2) new markets which will eventually become mass markets, and 3) markets affected by new economies of scale.

The principal attribute of the large corporation is its capacity to marshall and manage resources for the purpose of mass producing for mass markets. However, there are markets too small or too specialized for large firms—markets where economies of scale reach maximum efficiency points very quickly.

Examples of such businesses are all around us. Often we think of them in terms of various service and retail industries where quality and personal relationships are integral parts of a business sale—the private physician in contrast to the HMO, the boutique in contrast to K-Mart, the French restaurant in contrast to Howard Johnson's. But that is a far too limited view. It is no coincidence, for example, that the machine tool and metalworking machinery industries possess large proportions of small firms. The same is true of the home-repair industries. Both have a limited or specialized market where few economies of scale exist.

The critical value of these small and highly specialized markets is two-fold: first, it permits the large firms to obtain their inputs in the most efficient manner possible, and second, it provides the consumer with an infinite variety of products and services. Let me illustrate both points.

Efficiency: Think of a giant manufacturing firm—spread across the country and probably throughout the

John Sloan and Colleagues Examine Entrepreneurship at Hillsdale's Center for Constructive Alternatives

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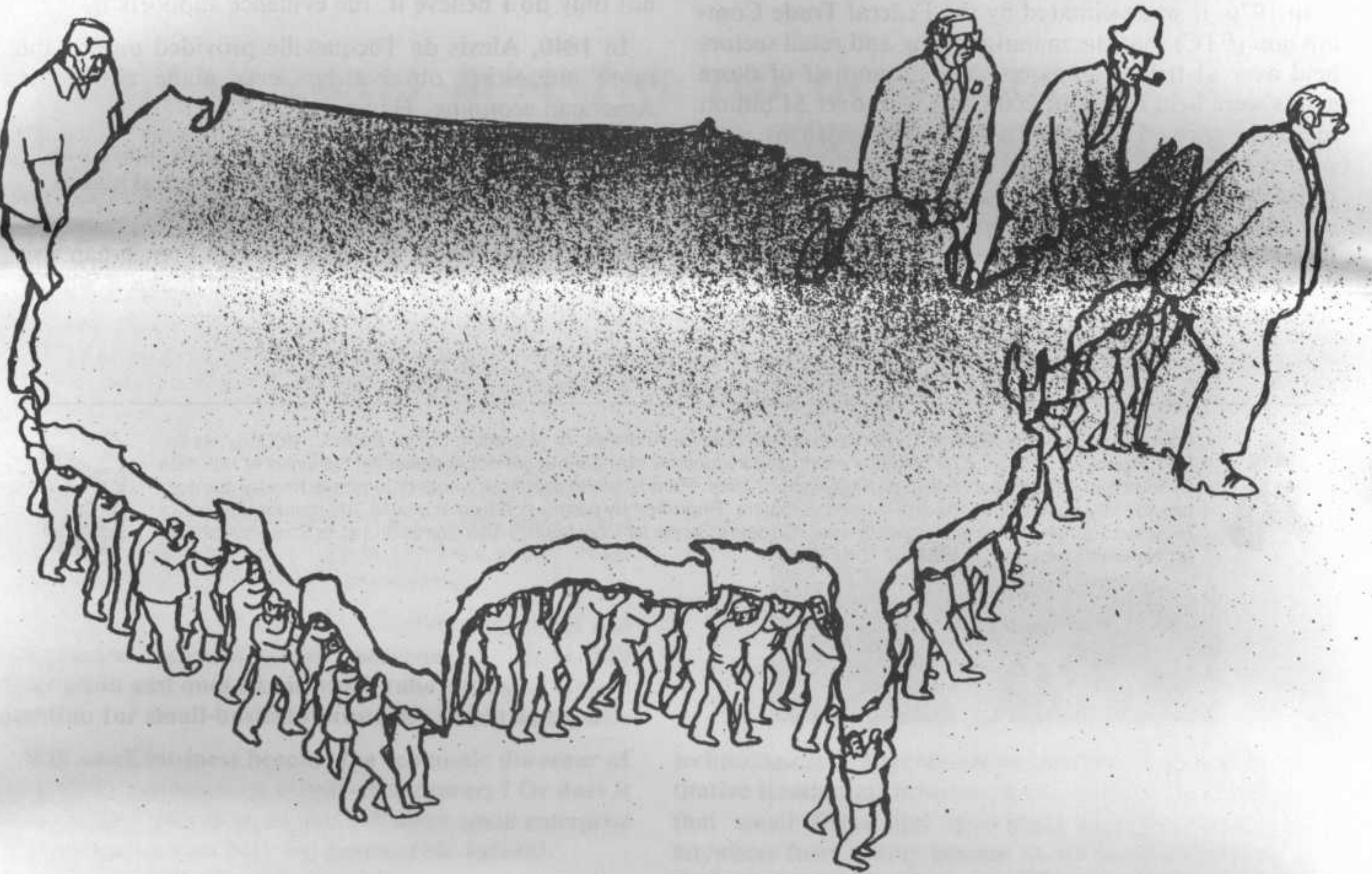
Mr. Sloan has been an active participant in small-business matters for many years. In June 1983, he was appointed to his third term as chairman of the National Advisory Council of the Small Business Administration. He has also served as chairman of the State Advisory Council of the SBA in Tennessee. Until he assumed his present position, he was a member of the Small Business Council of the Chamber of Commerce of the United States.

Like so many, John Sloan first became a friend of Hillsdale College when given a subscription to *Imprimis* several years ago. He is now formally associated with Hillsdale as a Distinguished Fellow of the Shavano Institute. This article is adapted from his presentation at a seminar of the Center for Constructive Alternatives in February 1984, on the topic "The Role of the Entrepreneur in a Free Society."

Other speakers at the seminar included professors Israel Kirzner of NYU and Karl Vesper of Washington; Jack Albertine of the American Business Conference; Robert Cizik, chairman and president of Cooper Industries; *Inc.* magazine editor Milton Stewart; and author George Gilder, also a Distinguished Fellow of the Shavano Institute.

world. The firm will have several in-house departments not inherent to its production process. For example, there may be a carpentry department, a mail room, reproduction facilities, etc. Wise management recognizes that in general these facilities should be kept at a point where they are constantly operating. You don't hire for a peak period; down time is expensive. But in-house mailing facilities get backlogged, reproduction machinery breaks down or there is an overload, and so on. It is no coincidence, therefore, the mailing, reproduction, and stenographic services industry consists almost exclusively of small businesses. Management and public relations firms, certain types of computer software, and testing laboratories have a somewhat similar size distribution in their industries. All these largely small-business functions serve to support mass producers for mass markets.



Variety: After test marketing, McDonald's decided not to introduce its new McRib barbeque sandwich. Apparently, it wasn't readily accepted in all sections of the country. Now, I happen to like barbeque. However, the efficiencies gained by McDonald's through a national menu would not have allowed me the choice of eating a barbeque sandwich should my choice of restaurants be limited to a national chain.

Small or specialized markets often function as *the* market in a geographically defined area, most notably in the rural regions. Here, small firms operate in substantially greater numbers on a per capita basis than in urban areas primarily due to the number of retailers. In the really remote areas, small business provides, in one form or another, the only goods and services that are available.

Small firms also fill gaps by initially producing products or services that after a certain point become mass products for mass markets. In one sense, this idea is an extension of the technology and technological innovation point previously noted. This is a very risky business for a small firm since it must either eventually grow and compete head-on with large firms, or perish. The personal computer business is a case in point, and the divergent fates of Apple and Osbourne battling IBM the best single example available.

We are now witnessing a devolution of many large production units in response to new, smaller economies of scale resulting from the broad movement of our developed economy into the service industries and from inherent problems in adapting a hierarchical organization to the cultural and social values of our increasingly educated society.

Norman Macrae, one of the few thoughtful people on the subject, attributes two fundamental difficulties to Henry Ford's hierarchical structure, the structure which has made several nations, including our own, rich. Macrae sees these difficulties as a "people problem" and an "enterprise problem." The former stems from the notion that educated people do not like to be run from the top down. Macrae argues that industrialized nations have attempted to cope with people in three ways, importing more amenable workers from poorer countries, sending multi-national factories to less developed parts of the world, and trying to persuade natives to love factories through use of worker participation groups. None have been, nor will be, truly successful for a variety of obvious reasons.

The "enterprise problem" is largely a function of automation. People are working with their muscles less and their brains more. Even within manufacturing industries, the proportion of people "on the line" vis-a-vis those in service or ancillary activities is diminishing. This is part of the entire economy's movement toward the service industries. **We have a new ballgame in the post-industrial economy—a ballgame far more conducive to operation of smaller firms than we have seen in the past several decades.**

And should you believe this evaluation provides a one-way ticket to economic disaster, let me simply point out that during the decade of the '70s, the number of Americans working rose an astonishing 26 percent. Those nations which have not yet felt and accepted the challenge of this new entrepreneurial era waned miserably in comparison—British employment grew 2 percent in the decade, for example; Japanese 9 percent; West Germany's actually declined. Thus, social and cultural values of an educated, independent people have combined with advancing technologies to alter our head-long rush to the "new industrial state."

Professor David L. Birch of MIT, in *The Job Generation Process,* determined that over half of the net new jobs created between 1969 and 1976 were in independent businesses. He also found that 80 percent were in business locations or establishments with fewer than 100 employees, and in businesses less than five years old.

The profile of the job generating firm according to Birch is as follows: It is small. It tends to be independent. It is volatile. This profile does not change much across industries and regions.

Peter Drucker noted that between 1981 and 1983, the Fortune 500 lost a total of three million domestic jobs. "Entrepreneurial business," as he calls it, added approximately one million.

The Birch data really shouldn't have been as surprising as they were. If indeed the role of larger firms is to mass produce for mass markets and the role of small firms is to fill old gaps and create new ones, then almost by definition we should expect that an implicit attribute of small business will be job generation—at least relative to other economic structures. Moreover, we should expect many of these jobs to be particularly suited for certain groups of people. And they are.

An important function of small business is to provide the bulk of jobs and hence a large share of on-the-job training for young Americans. This is a function largely thrust on small business due to the price-fixing activities of the government and organized labor, such as minimum wage, Davis-Bacon, etc. But it is more complicated than that. Small firms by definition have a modest hierarchy, and usually face a competitive condition which does not permit wages, particularly at the entry level, to rise far above market value. The result is a concentration of young, less experienced employees whose initial conditioning to the workplace must be accomplished by small employers.

We are only beginning to explore the role of small firms in the business cycle and their interaction with larger firms in general economic phenomena. But we know that role is a dynamic one.

For example, our own work at NFIB demonstrates *that* small enterpreneurs and small-business owners, *in aggregate,* often prove far more sensitive to approaching market developments than do all the econometricians with all their sophisticated mathematical models.

David Mills at the University of Virginia, provides evidence that assigns small firms the role of industrial "shock absorbers." His argument runs: "Large firms produce more efficiently at normal levels of demand, but small firms are more flexible and produce more efficiently when demand is very high or very low. Thus, small businesses are a stabilizing factor particularly in industries experiencing significant demand fluctuations due to cyclical factors."

Small business also enhances operation of the free market. Put another way, it doesn't have the potential to detract from operation of the free market.

Chrysler is a case in point. Chrysler management and the United Auto Workers (UAW) leadership made a series of ghastly errors in the '60s and '70s. The penalty imposed by market discipline was bankruptcy, and Chrysler was clearly headed in that direction. Lee Iacocca came to Washington, tin cup in hand, pleading for a bail-out. Despite the confusing rhetoric, Chrysler's argument was that the company was too big to fail; there were too many employees; there were too many stockholders; there were too many small-business suppliers. The Carter Administration and the Congress swallowed the argument, and the rest is history. Chrysler has survived, repaid its creditors, and helped bludgeon the Reagan Administration into another new bailout scheme—import quotas.

The point of this episode is not to chastise Chrysler or Mr. Iacocca; the point is to demonstrate that large firms have the capacity to distort and interrupt operation of free markets. In this instance, the distortion occurred due to political activity. Small businesses usually cannot follow suit, though I would concede that there are those that would do so if they believed they could. Market discipline dooms a foundering small business to failure. The broader benefit of such personally unfortunate incidents is to reduce the total cost of unsuccessful ventures.

By extracting a penalty recognizable to both the public and the business community, superfluous efforts and fly-by-night operations are winnowed. Thus, penalty is every bit as much a part of the incentive structure as is reward.

E. F. Shumacher's book *Small Is Beautiful* was a favorite in the late '70s, particularly among those who considered themselves "socially and environmentally conscious." The book's central thesis, that small-scale technologies and small economic units serve social (including quality of life) functions as well as economic purposes, was important. But unfortunately, proponents of Schumacher's thesis, led by Governor Jerry Brown of California, blindly kept the discussion in terms of "small is beautiful," instead of "small is beautiful and economically efficient." Free-market advocates responded by largely dismissing or ignoring Schumacher's thesis. *So, what resulted was that two perspectives, often at odds, missed their essential compatibility when it came* to small business. Yes, small business is highly efficient in various markets, as we have seen. Yes, small business provides enormous social functions, as we are about to see. And one doesn't necessarily detract from the other.

What motivates the entrepreneur? What attracts people into small business?

In my judgment, no one factor is the primary motivation for entrepreneurial endeavor. There are many, and often they are complexly interwoven within the same individual. Financial reward or profit is obviously one type of motivation; independence or being one's own boss is another; doing what the individual likes to do is yet a third.

The only real evidence one needs to prove that entrepreneurial endeavor fulfills some personal need is to note that an increasingly large percentage of Americans is involved—over 10 percent of adults in 1977 contrasted to only about 8 percent just 30 years earlier. These data represent an historic reversal in the fortunes of small entrepreneurs. The full effect of the Industrial Revolution, including the farm to city migration, on the proportion of entrepreneurs appears to have passed.

These data also confirm the results of numerous opinion polls which consistently conclude that self-employment or small-business ownership is a highly desirable occupation. For example, 3,300 high school seniors surveyed by the University of Michigan preferred self-employment, followed by employment in a small business. Employment in larger institutions such as big business, government, military, was well down the list. A poll conducted by *U.S. News* found that of 25 major socio-economic entities, small business ranked third in a combination of integrity, dependability and influence. Only science and technology, and television and radio news had higher combined scores.

While there is no empirical evidence of which I am aware directly and systematically linking entrepreneurial activity to personal rises in social and economic status, it is clear various individuals and immigrant groups have used small businesses to that end. Jewish Americans, Chinese Americans, and most recently Cuban Americans are highly visible examples. Each of these immigrant groups faced language barriers which often closed doors to them. But the entrepreneurial door has always been wide open. Many have successfully passed through. However black Americans, economically the poorest major identifiable ethnic group in the United States, to this day have not. They remain grossly underrepresented in the entrepreneurial population.

For most communities, it is the small-business population that provides a community with its identity, its hope, its goodwill, and its spiritual leadership—and often without the occasional obstrusiveness or beneficence associated with large firms.

A few years ago, NFIB conducted a survey of its urban members. One of the questions asked was, "Overall, what do you think of your city's prospects for economic improvement in the next twenty years?" As expected, small-business owners in more affluent, rapidly growing areas evaluated their prospects more favorably than did those in non-affluent areas. The surprise was small-business owners located in some of our more distressed cities, —the Detroits, the Newarks, etc. Seventy percent of this group believed the future economic prospects of their city were average or better with more of them believing that their cities would grow at above average rates than at below average rates.

The community cannot remain strong without the confidence of its business community—and it is the small-business owner who provides that confidence where and when it is needed most. Most small entrepreneurs are indigeneous; their businesses are located where they live and usually have lived for several years prior to business entry. There is a personal commitment of the small-business owner to the community which extends beyond the interests of his business—a commitment that can be found over and over again, in small business after small business, in city after city across the country.

Finally, small business disperses economic decision-making within our society.

Please note I used the term "economic decision making" rather than "ownership." The fact that more than 30 million Americans own stock directly and with some overlapping, another 30 million indirectly through vested pension rights is to be applauded. However, dispersal of ownership is not tantamount to dispersal of decision-making, and broad decision-making, at least in a democratic society is important, if not more so than broad ownership.

The owner of a small business has some economic decision-making power. He can set prices, make or not make investments, move or retain his location, hire or lay-off employees, and so on. Obviously, these decisions cannot be made in a vacuum—devoid of market and other considerations. But he does exercise some influence which in concert with the influence exercised by others effectively defines operation of a market. In contrast, the individual possessing stock ownership in a large firm usually has absolutely no decision-making power. The best he can hope to do under normal circumstances is harass management once a year at the annual shareholder's meeting.

In 1976, it was estimated by the Federal Trade Commission (FTC) that the manufacturing and retail sectors held over $1 trillion in assets. More than half of those assets were held by about 200 firms with over $1 billion in assets each. Those relatively few large firms were owned by a hefty percentage of the nation's 30 million direct stockholders. Yet, how many stockholders had any say over any decision made by the corporation? Very few. Contrast that with the decision-making capacity of the small-business owner. His share of assets was individually minimal, but he determines their entire disposition. In such a manner, small business serves to disperse the nation's economic decision-making power.

Does small business play a significant role in our economy and our society?

Without hesitation, I will tell you that it does. I will also tell you I believe small business will continue to play a significant role in our economy and in our society. But not only do I believe it, the evidence supports it.

In 1840, Alexis de Tocqueville provided one of the more interesting observations ever made about the American economy. He wrote:

> ...what most astonished me in the United States was not so much the grandeur of some undertakings as the innumerable multitude of small ones.

I think that should an equally observant Frenchman visit this land in the year 2040, he would make a similar observation.

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