Employers Large and Small: A Review Article

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The role of small businesses in economic growth and development has often been exaggerated by politicians, distorted by the press, and trivialized by mainstream economists. But, scholars continue to search the journals and book shelves for research which will clarify the myths and set the record straight. Brown, Hamilton and Medoff's new book, *Employers Large and Small* is a relatively short, easy to read book which proposes to separate myth from reality: "The prevailing wisdom about large and small firms should be reexamined because in at least two instances, job creation and political power, it is wrong." Since the book's anti-small business conclusions are controversial, it has aroused media attention and therefore requires a careful review.

The book's strength lies in its scholarly discussion of the environment of small and large businesses. Its weaknesses lie in an unconvincing discussion of the job generation research and a disappointing effort to redefine small businesses as wealthy and politically powerful. It does not accomplish its objectives.

Eight elements describing large and small employers in the economy[1]

The book begins with Brown, Hamilton and Medoff challenging readers to re-examine the prevailing wisdom about small and large businesses. The authors offer eight "elements" (pp. 2—4) that constitute the focus of the book and lead to their conclusion that small businesses do not deserve their special reputation as sources of economic change, new jobs, new ideas and new ways of treating employees.

Their "eight elements" are central to their conclusions so they shall be listed and discussed here. I have combined them into three categories (the authors do not) for ease in explication here.

Job generation

Element one states that small businesses do not create a particularly impressive share of new jobs. The authors argue that, contrary to widely quoted statistics, small firm created jobs amount to little more than small firms' share of total employment. This assertion is contrary to much of the job creation research since David Birch's first discovery in 1979 (Birch, 1979) and therefore requires extensive treatment in this review.

Quality of work environment

The next five elements deal with the topic of quality of work environment, i.e., how good are work environments in small compared to large businesses. The term "work environment" is used by the authors to mean the terms of employment (e.g., hours of work, wages, fringe benefits, etc.) not the conditions of the work place (e.g., temperature, cleanliness, saftety, etc.).

Element two states that large employers offer much higher wages than small employers. The third and fourth state that large employers offer better benefits and that small businesses' lower benefits are due to higher per employee cost. This argument is presented in a persuasive way thereby demonstrating the authors' strength in this area of research. These elements deserve further discussion in this review.

Element five states that large employers' better benefits are not offered to offset inferior working

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conditions found in large firms. The authors propose this element in response to economists who have argued that there must be a reason why small firms are successful in hiring employees at lower wages. The logic of this classical economics argument is that if we assume labor markets are efficient, small firms must offer some other non-pecuniary compensation in order to hire employees, e.g., better working conditions and more job security, to offset lower wages. This classical economics argument lacks persuasiveness since few economists believe that labor markets are efficient. And the authors' efforts to refute it rest largely on assumptions about paper and pencil questionnaire measures of job satisfaction that are equally lacking in persuasiveness. Since this element is weak in theory and measurement and is not central to the book's main focus, it will receive no further discussion in this review.

Element six states that new jobs created by large firms offer greater security than those created by small firms. This argument has been advanced by others and will receive attention in this review.

Wealth and power

The last two elements, seven and eight, are designed to change the public perception of small business persons as ordinary, middle class people without significant political power. Element seven says that owners of small firms have higher incomes and assets than average Americans. This element, by position in the list immediately after the discussion of poor work environments, leads the reader to infer that small firms extract excess profits by paying low wages and fewer benefits to their workers.

Element eight states that small firms posses significant political resources in comparison to large firms and labor unions. This element is presented in an attempt to refute the perception of small businesses as underdogs when dealing with big government, big unions and big businesses. Both element seven and eight are worthy of careful scrutiny because both are based upon flawed research.

After chapter one's list of eight elements, the book is not organized in the order in which the eight elemets are listed nor do the elements appear as chapter titles. Thus, moving directly from chapter one into an element by element analysis is not possible. However, for the readers of this review, I will create an element by element analysis.

Element one — Job generation

Brown, Hamilton and Medoff attempt to undermine a principal research finding about job generation, i.e., that small firms create the most net new jobs. They begin by stating the Birch's original work is troubled by his practice of classifying business size by "... number of people working at a given location rather than by the number working for the firm in total ..." (p. 2). Their statement is contrary to Birch's own statement that he analyzed on the basis of enterprises not establishments (Birch, 1979). They justify their statement by noting that SBA reported that small firms created 53 percent of the new jobs, a significantly smaller share than Birch reported. However, they fail to note that SBA's work does not cover the same period of time as Birch's research, that small businesses' share varies over time, and that SBA has reported small businesses' shares as high as 96 percent in 1980—82. Later, in Chapter 2, they use Birch's statistics to develop their own argument about job generation, apparently in contradiction to their "troubles" with his research.

The intent of their analysis is to demonstrate that "... many of the beliefs about job generation that greatly condition policy are inconsistent with the facts" (p. 19). The trouble is that their analysis focuses on refuting "beliefs" rather than developing a logical model of what the available research facts mean. This results in a series of sections, each on a specific belief, which when combined do not lead to a consistent understanding of the whole.

The essence of their logic seems to be that since the small firm sector's employment share is not growing, then small firms cannot be creating large amounts of jobs. "The stability of the small business share is difficult to understand if one's image of small firms is as prodigious job generators" (p. 26). This comment on employment share statistics is correct and has puzzled economists for years. But, conventional comparative static analysis of employment shares cannot explain dynamics. Comparative static analysis assumes that inter-sector movement of firms is negligible, and, therefore, sector employment changes (or non-changes) are due to the firms within the sector, not to movement of firms from sector to sector. In fact, however, when a small firm grows by adding several hundred jobs, its entire employment moves from the small to the large sector. For example, if a firm with 90 employees in 1984 grows to 590 employees in 1986, the small firm sector in 1986 reports a loss of 90 employees and the large firm sector gains 590. Thus, the rapid growth of a small firm actually reduces small firm sector employment as measured by comparative statics because its base year employment is subtracted from the small and added to the large sector. But, in dynamic measurement methods, this small firm generated 500 new jobs. In all, there are four "inter-sector" dynamics that affect static totals in this non-conventional way. This, however, is not the place to discuss these issues. Suffice it to say that those who do understand dynamic measurement methods have no difficulty understanding how small firms generate jobs in excess of their unchanging comparative static share of employment.

To explain why their comparative static conclusion stands in sharp contrast to SBA's and Birch's statistics, Brown, Hamilton and Medoff first note correctly that new firm births constitute more than 100 percent of the net new jobs created in any biennial period from 1976 through 1988. And, then they discount the importance of new firm births to job generation by arguing that new firms are small by an "accident of birth" (p. 24). Second, they examine the evidence and correctly note that small firm employment growth is concentrated in only ten to fifteen percent of firms within the small firm sector. Then, they argue that small growing firms belong to the large business sector. "Moreover, really successful small businesses grow until they become large — and no longer contribute to small business's share of employment" (p. 26).

Brown, Hamilton and Medoff have merely come upon the already known conclusion that the real job creation activity comes from two components of the small business sector, (1) new firms; and (2) high growth firms. They choose to "tighten" the definition of the entire small business sector because heretofore it has had an imprecise definition (small size) that mixes small declining and dying frims in with small forming and growing firms. The problem is that no one has the tools to identify the potential growth firms from the potential dying and/or declining firms. The authors offer policy makers no advice about how to find these in the heterogeneous mix of small businesses nor do they offer policy prescriptions for the new and growing firms which they have identified as the growth segment.

Quality of work environment

This is the central theme of the book evidenced by five of the eight elements (2 through 6) in their list. Brown, Hamilton and Medoff demonstrate their scholarly strengths in analyzing the wages and benefits issue (elements two, three and four) in chapters four and five. They use a comprehensive review of the research literature including some of their own research to effectively argue that small businesses provide jobs with lower pay and fewer fringe benefits, specifically, health care benefits. Thus, they conclude, small businesses offer poorer quality work environments compared to large businesses.

Although not the first to advance this view (see: Bluestone and Harrison, 1982, they provide a well documented, scholarly analysis worth reading. Although the authors provide no explanation of why small employers pay lower wages and supply fewer benefits, this section should be required reading for researchers who study small businesses.

Their conclusions are disturbing but the only response researchers have made so far is to mumble about the inadequacy of existing data bases, statistical distortions of average measures, effects of part time employment, and the like. Hopefully the issues raised by *Employers Large and Small* will stimulate some meaningful research on these topics.

On the other hand, the authors' correct conclusion that small firms do not offer health benefits because they experience higher per worker costs for health care insurance should have led then to include some reference to why these costs are higher. Small firms and their employees are victimized by a health care system that retains an archaic actuarial tradition of defining insurance groups on an employer base rather than a community base. Small firms have higher insurance rates because their enrollment base (group) is smaller and therefore entails higher actuarial risk. If the enrollment system was based on the community, insurance risk (rates) for all members of the community would be equal. Then all insureds, whether employed by "employers large or small," would pay the same insurance rates.

Employment security

Element number six states that large businesses have lower layoff rates (percent of work force) than small businesses. This, the authors claim, means that large firms offer greater job security. They briefly cite several research studies which support their percentage change assertion (pp. 26—27, 53—54).

But, percentage changes are an inappropriate comparison method since the employment base of the two groups is so different. Large corporations who lay off ten percent of their work force may lay off hundreds or even thousands of employees. Small firms who lay off ten percent of their work force may lay off only one to ten. The overall social and economic impact is quite different. Accurate comparison requires an examination of the gross effect of all small and all large firms upon changes in number of jobs.

Research by Bruce Phillips and I (1988) on the gross employment changes due to formation, expansion, contraction and termination of establishments owned by both large and small firms from 1976 through 1984 shows that large firms' share of employment losses due to establishment exits and contractions is about the same as their share of employment. Phillips and I conclude that both large and small firms experience employment declines about equivalent to their employment shares. Small firm jobs are as secure as large firm jobs.

Labor exploitation?

Element seven asserts that owners of small firms have higher incomes and assets than average Americans. Brown, Hamilton and Medoff do not specifically denote that small firms extract excess profits by paying low wages and offering fewer benefits to their workers but a reader can scarcely finish the book without sensing that this conclusion is intended.

The evidence they present to support element seven is weak. The topic does not even have a chapter of its own. Instead, the evidence appears within the discussion of the element (p. 4) and as two pages within the second chapter (pp. 15—17). Their evidence derives from a unpublished 1983 survey. Their claim is that this unpublished survey shows: "The owners of small firms enjoy incomes and assets higher than those of the average American," and, ". . . families who owned small businesses had incomes that were 1.8 times higher than the income of the average U.S. family and owned assets that were more than five times as large." (p. 4) They do not provide data or other evidence from the survey to support these claims.

One must be cautious of comparing small firm owners to the population averages since formation and operation of small firms is an effective method for individuals (families) to achieve upward economic mobility. Thus, small business ownership attracts ambitious workers. In a way, the findings of this survey merely confirm the value of small business ownership in providing upward economic mobility and economic development.

Obviously, a better group for income and wealth comparison is large business owners, a comparison the authors make. Upon presenting and analyzing the available evidence comparing large business owners with small, they conclude: "Thus, the existing, far from ideal data suggest that owners of small businesses are somewhat wealthier but report somewhat lower incomes than owners of stock in larger firms. What is quite clear is that owners of businesses of any size are a good deal wealthier than the rest of the population." (p. 17) These conclusions are much weaker than that stated in element number seven.

Political power

Element eight, that small firm sector ". . . posses significant political resources in terms of PAC dollars, lobbying staff and public support . . ." is a strong assertion defended with a detailed research analysis. The authors' argument and two chapters of political analysis depend on a research definition of which political action committees (PACs) and trade associations represent small businesses. The authors' choice for a research definition is: "Small business PACs were designated as coming from trade associations or groups representing industries in which the majority of workers were employed in firms with fewer than 500 people." (p. 67)

Application of this criterion yields an arcane list that includes the American Medical Association PAC and the Association of Trial Lawyers PAC as two of five "small business PACs' " among the ten "biggest spending" PACs. (p. 69) The other three are also industry trade associations: Realtors, home builders, and life underwriters. None of the small business trade associations are among the top ten.

The authors should have checked to see if their classification scheme had any face validity. No politician associates AMA and the Trial Lawyers with small business issues. I know no one in the popular news media who would select these as small business PACs. These are trade associations that focus on issues relevant to their professions, not on the size of their members' firms. In fact, although both private medicine and law are small firm dominated industries, neither of these trade associations have a history of, or are currently in agreement with the two largest small business trade associations, the National Federation of Independent Business (NFIB) and National Small Business United (NSBU), on any major issues. AMA favors mandated universal health care; NFIB and NSBU do not. The trial lawyers oppose tort reform on product liability and favored the Americans for Disability Act. NFIB and NSBU favor the former and opposed the latter.

Although I am not familiar with the positions of the other three industry trade associations they declare to be "small business," I suspect they are similarly oriented to their trades, not the size of their members' firms. Still, the contradiction implied by these two associations is enough to discount the authors' analysis. Removing only these two reduces the total financial role of the five so significantly that their analysis would yield completely different results.

The book presents a politically sensational hypothesis — small businesses have power. But, its justification lies in a bad research definition which yields outcomes in obvious conflict with real world facts. The small business sector is characterized more by diversity of owners, industries and politics than by clear direction of any kind. One only needs to review the record of the 1986 White House Conference on small Business to realize what a politically diverse, issue divided, powerless group the small business sector is.

Summary

Brown, Hamilton and Medoff add little to the advancement of our understanding of small businesses by giving us another book that arouses passions, stimulates the controversy hungry news media, but leaves the reader with a sense of unfulfilled promise. They convincingly prove only three of their eight elements. Their good analysis on the work environment topic is lost in the morass of small business sector re-definition and erroneous political action committee research assumptions.

At worst, this book will create controversy on small businesses' role in job creation just as many former socialist nations turn to the U.S. for advice on how to revitalize their economies. Small business formation, survival and growth is the brightest hope for these nations.

After all, *employers small, not large* create the majority of new jobs in America.

Note

1 Throughout this review, I will cite page numbers for the Brown, Hamilton and Medoff book so as to assist the reader in researching the book for his/her own interests.

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