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THE WORLD OF SMALL BUSINESS: TURBULENCE AND SURVIVAL

by Ann R. Markusen and Michael B. Teitz

SMALL BUSINESS AS REGIONAL EMPLOYMENT GENERATOR

Traditionally, the engine of local and regional economic development and employment growth has been perceived to be investment in new or expanded large-scale industrial or commercial facilities. Indeed, that is the basis upon which the greater part of local development efforts still rely. In recent years, however, an alternative view has been put forward and widely accepted. This view sees small business as a key element in economic development, and, especially, in the generation of new employment. While not without its critics, this conception of small business as a principal source of innovation and dynamism in local and regional economies suggests the need for careful assessment of the role and nature of small business. Such an assessment has thus far been based largely on statistical analysis of the employment-generating effects of small business. The intent of this paper is to complement that work with a grounded picture of small business as revealed in case interviews with a limited number of firms. But before discussing the results of the survey, it is useful to recapitulate the status of investigations into the role of small business in the aggregate.

In the United States, research on the employment effects of small business is largely associated with the work of David Birch. Birch's initial study (1979) was based on a very large data file of firms collected by Dun and Bradstreet, a credit rating organization. According to his estimate, firms with twenty or fewer employees accounted for 66 percent of net employment growth in the United States between 1969 and 1976. Subsequent work has both supported and challenged Birch's findings. Teitz et al. (1981) analyzed an unemployment insurance data set representing virtually all firms in California for the period 1975-1979. They found that firms in this size category produced some 56 percent of net new jobs in the state. More importantly, this work suggested that the dynamics of employment generation were such that much of that total may be due to a relatively small number of fast-growing firms.

Birch's work has been criticized on several grounds. Amrington and Odle (1982) have also analyzed the Dun and Bradstreet data, but come to rather different conclusions. They argue that the large proportion of employment generated by small business may be due to the use of establishment data that suppress the connection of small units to larger parent firms. This debate is not yet resolved. A further question of the quality and stability of jobs created in small firms is raised by Gordon (1979) and Bluestone and Harrison (1980), both of whom assert that the higher attrition experienced by small firms dooms most of the jobs that they create to be short-term. This characteristic has long been noticed in studies of the dynamics of populations of firms, for example Ijiri and Simon (1977). In addition, small businesses may exhibit lower productivity and pay lower wages than large firms. Fothergill and Gudgin (1979) question whether Birch's results depend on the growth of the service sector in the United States. Their analysis of manufacturing firms in the British East Midlands region indicated only a modest contribution by small businesses. Teitz et al. (1981) also showed a lower rate of job generation in manufacturing by small firms.

Despite these criticisms, the idea that small business is important to economic development and employment growth is now well established. Local and regional agencies are incorporating small business development explicitly into their development strategies. Research on small business behavior and its contribution to development and employment is continuing. At the same time, aggregate analysis alone is insufficient for the development of policy. If small businesses are to be fostered and encouraged, we need to know more about the way in which they are founded, survive, grow, and fail. Such understanding comes from analysis of the reality in which these firms live and function. That is the aim of this paper.

THE SURVEY AND INTERVIEWS

The small buiness environment was investigated by interviewing a sample of twenty-eight Bay Area small businesses, chosen at random and covering a range of employment size categories and sectors. Unlike many other studies, the sample was not restricted to the manufacturing sector; rather, representative firms were chosen from all sectors, including wholesaling, retailing, business and personal services, construction, transportation, and finance, insurance and real estate (FIRE).[1]

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[1]Three basic job-size categories (1-5, 6-49, and 5Ø-1ØØ) were employed. The basic aim of the study was to develop, in detail, a fairly small number of case studies rather than undertake a comprehensive and statistically verifiable analysis. However, an attempt was made to ensure that a reasonable cross section of firms (by sector and by size) were included in the study. The sample itself was constructed in two stages. First, a pre-test was designed to test the business information directory and the survey questionnaire. Second, a larger sample was subsequently drawn for use with a revised form. Since the business directory proved satisfactory and the survey revisions basically involved format changes rather than ones of substance, the results of the two samples were combined in the report. Both samples were stratified by selected

Within the size and sectoral categories, firms were selected from the SIC index edition of the Contacts Influential Commerce & Industry Directory; East Bay Edition. (Influential Contacts, Ltd., 1979.)[2] No attempt was made to control for geographic location within the East Bay Area.

The actual selection of the firms from the directory was statistically random. Table 1 shows the composition of the combined sample from the pretest and the main survey. The composition by sector and by size category of the final sample is shown in Table 2. The firms are fairly evenly distributed throughout the size range. Table 3 indicates how the sectoral distribution of firms in the sample compares with the statewide distribution. It should be noted that the small number of cases in each sector and size category cautions against generalizing along either of

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Standard Industrial Classification (SIC) sectors and by business employment size categories. In the pre-test, the sectors covered were manufacturing, retail, and services, and the size categories were 1-5, 6-10, 11-25, and 26-50 employees. In the main sample, the construction, transportation, wholesale and financial, insurance and real estate sectors were added. SIC designation was controlled for only at the single-digit level and not for two-digit SIC industry groups. One exception to this procedure occurred in the manufacturing sector which was divided into durable and non-durable sections with an equal number of firms taken from each. Finally, the size categories in the main sample were restructured and expanded into three larger groups: 1-5, 6-49, 50-100.

[2]Contacts Influential was used because the range of information it contains is superior to other business directories. Besides SIC designation and employment size, it was deemed important to know the key individuals in the firms in order to assure proper contact. Contacts Influential indicates for each establishment listed whether it is a headquarters, a branch, or a local independent. However, the employment figures presented in the directory for headquarters and branches refer to the establishment listed, rather than the entire firm. Thus, the auto repair firm was included in the pre-test with the expectation that it had 26 to 50 employees. In fact, the firm had a total employment of well over 100. Consequently, headquarters and branches were excluded from the main sample. Several of the local independents interviewed had branches of their own, but the total employment data were reasonably accurate as Table 2 suggests.

Table 1

<u>STRUCTURE OF THE INITIAL TOTAL SAMPLE INCLUDING PRE-TEST</u>

	SECTOR		NUMBER		
			1-5	6-49	50-100
Manufacturing	15	23.8%	5	6	4
Construction	6	9.5	2	2	2
Transportation	3	4.8	1	1	1
Wholesale	6	9.5	2	2	2
Retail	14	22.2	5	6	3
Services	13	20.6	4	6	3
FIRE	6	9.5	2	2	2
Total	63	100.0	21	25	17

Notes:

[a]Based on information in the <u>Contacts Influential Directory</u>.

[b]Total may not add to 100 percent owing to rounding.

Table 2

FINAL SAMPLE STRUCTURE BY SIZE AND SECTOR

	SECTOR	NUMBER		
		1-5	6-49	50-100
Manufacturing	5	1	3	1
Construction	2	1		1
Transportation	2	1	1	
Wholesale	1			
Retail	8	3	3	2
Services	5	1	1	3
FIRE	2	1		1
Total	28	10	9	9
Percent Response	44%			

Notes:

[a]Based on actual figures obtained from the firms during interviews.

[b]One with more than 100 employees.

Table 3

COMPARISON OF PERCENTAGE DISTRIBUTIONS OF FIRMS IN SAMPLE AND STATEWIDE

SECTOR	FINAL SAMPLE (FIRMS)	STATEWIDE[a] (REPORTING UNITS)
Manufacturing	17%	9.2%
Construction	7.1	10.4
Transportation	7.1	3.4
Wholesale	14.3	8.2
Retail	28.6	24.4
Services	17.9	35.4
FIRE	7.1	8.9
Total	100.0%	100.0%[b]
	N = 28	N = 419,288

Notes:

[a] Adjusted to exclude other sectors from the total. Derived from the California Employment Development Department, 524 Report.

[b] Percentages may not add to 100 owing to rounding.

these dimensions. The point, rather, was to ensure coverage of all types of small businesses.

The survey itself probed small business experience first-hand to find out what conditions were affecting the business in both the short- and long-run, and to test old, and generate new, hypotheses about the problems and prospects of small business. Unlike most small business surveys, which deal with only one or two issues, our objective was to elicit a broad range of experiences in the operation of small businesses. Interview questions were therefore structured to develop both qualitative and quantitative responses on a broad spectrum of topics, including the business environment, entrepreneurship, finance capital, labor, location and physical facilities, other private sector factors, and the effect of the public sector, especially taxes and regulation.[3] Table 4 summarizes the general characteristics of the firms surveyed.

THE COMPETITIVE ENVIRONMENT

The survey sought first to gain a picture of the conditions influencing the operation and development of the small businesses in the sample. Informants were asked about the underlying dynamics affecting

[3] A number of sources proved helpful in the development of the case-study interview questionnaire, including the industry case study methods used by the Political Economy of New England Project (Investigators: Barry Bluestone and Bennett Harrison, Joint Center for Urban Studies of MIT and Harvard, 1979); The Employment Needs Survey of the Oakland Private Industry Council (1980); questionnaires designed by Economic Research Associates (Oakland); and a study of small business (Kieschnick, 1979). Several pre-survey discussions were also held with small business entrepreneurs.

Table 4

CHARACTERISTICS OF SAMPLE FIRMS

Firm, by Industry	Location	Number of Employees	Gross Annual Sales	Age of Firm (Years)	Ownership Status
A. Manufacturing					
Aerial Security Systems	San Leandro	40	$3 million	52	Closely-held corp.
Container Products	Hayward	34	$3 million	5	Corporation
Fiber Production	Union City	85	$800,000	18	Corporation
Recreation Equipment	Hayward	3	$250,000	17	Partnership
Wood Products	Oakland	7	$1.2 - 1.5 million	87	Closely-held corp.
B. Construction					
Excavation	San Leandro	5	$164,000	16	Partnership
Underground Utilities	Concord	85	$2 - 8 million	30	Corporation
C. Transportation					
Air Transportation	Oakland	65	$1 - 2.5 million	6	Corporation
Emergency Transportation	Walnut Creek	40	$1 million	33	Closely-held corp.
D. Wholesale					
Book Publisher/Distributor	Benicia	2	$1.4 million	6	Corporation
Building Supplies	San Leandro	6	$1.8 million	15	Corporation
Furniture Importer	Oakland	2	$150 - 250,000	31	Proprietor
Machine Tool Distributor	Oakland	2	$300,000	11	Proprietor
E. Retail					
Florist	Walnut Creek	6	$275,000	20	Closely-held corp.
Food Market (a)	Pittsburg	4	$500,000	18	Proprietor

Table 4, continued:

Firm, by Industry	Location	Number of Employees	Gross Annual Sales	Age of Firm (Years)	Ownership Status
Food Market (b)	San Pablo	85	$11 million	50	Closely-held corp.
Food Market (c)	Lafayette	100	$15 million	12	Closely-held corp.
Liquor Store	Berkeley	2	$175,000	33	Proprietor
Paint Store	San Leandro	3	$400,000	25	CLosely-held corp.
Recreational Vehicles	San Leandro	22-25	$3 million	12	Closely-held corp.
Restaurant	Hayward	8	$140,000	15	Partnership
F. Services					
Advertising Firm	Oakland	4	$450,000	26	Corporation
Auto Repair	San Leandro	165	$6 million	38	Corporation
Dry Cleaning	Berkeley	7	N/A	5	Closely-held corp.
Health Maintenance Organization	Berkeley/ Oakland	70	N/A	10	Non-profit
Marketing Research	El Cerrito	55	$350,000	4	Parternership
G. Finance, Insurance, Real Estate					
Realtor		6	N/A	13	Proprietorship
Securities Investment	Oakland	65	$7.5 million	N/A	Partnership

Number of firms in Sample = 28

their businesses, the role played by competition, strategies employed to overcome adverse dynamic and competitive factors, and attitudes toward growth and innovation.

Underlying Dynamics

Small businesses are often depicted as being either very risky and short-lived or else very stable, permanent residents of the local economy. Our survey turned up evidence of a dynamic and turbulent environment. The longevity of businesses included in the sample was quite high; the mean age was nearly twenty-two years, while the median age was eighteen. However, most of the businesses were experiencing some kind of change. While eight were stagnant or declining, the rest were facing drastic crises (6), growing steadily (5) or expanding rapidly (11). Thus, the typical small business seemed to be facing some degree of uncertainty. Those who escaped tended to be local retailers in stable markets. Although the specific causes of change and stability were often complex, three types of factors appeared to be involved: cyclical, sectoral, or spatial.

Cyclical factors created problems for fourteen, or half of the firms. Five firms faced seasonal fluctuations in demand or supply conditions, causing severe although not necessarily fatal cash flow problems. Another firm was subject to agricultural cycles, which have at times lasted more than one season. By far the greatest number of cyclically-induced problems, however, originated in business cycle fluctuations and other general economic trends. Both recession and inflation posed major obstacles for these small businesses.

Recession operates on both the demand and supply sides of the small business economy. The current recession affects particularly those firms involved in construction, in wholesaling, and in supplying consumer services (including the restaurant) and retail goods (for example, the furniture supplier and the dealers in recreational vehicles and aviation equipment). Some firms were severely squeezed for cash as their customers stretched out their payments and accounts receivable rose. On the supply side, some firms found that their suppliers passed on the brunt of the recession to them--an aviation-related firm, for instance, had to absorb the manufacturer's excess output. A dealer in power tools reported that a big company with whom he competes gave unmatchable forty percent trade-in discounts to keep its volume up. Both types of problems reflect the small firm's vulnerability to tied-buying arrangements or oligopoly on the supply side.

The cyclical problem was compounded by inflation. As interest rates rose to reflect both inflation and uncertainty about future price increases, small business customers faced greater difficulties in financing purchases from wholesalers and durable goods dealers. Many encountered difficulties in repaying short-term borrowings. The aviation-related firm, for instance, seemed to be in a position where it could neither sell nor borrow to meet its debts. Rising costs had other effects too. A restaurateur noted that inflation lowered his volume and altered the clientele from families to young professionals as higher menu prices led to fewer meals served. Moreover, as one small manufacturer argued, inflation tended to break down traditional dealings between buyers and sellers. Previously, he pointed out, small businesses would resist, negotiate, and haggle with suppliers and buyers over prices. With permanent inflation, increases are just passed on automatically.

Sectoral causes--the second major group of factors underlying instability--were specific to each industry and were frequently related to product-cycle developments. For instance, a small furniture dealer selling imported Norwegian furniture had at one time distributed throughout the country and employed more than twenty workers. By the late 1970s, he had retrenched to a three-person operation. The rise and fall of his business can be traced to the fashionableness and innovativeness of this style of furniture in the 1950s and 1960s and its imitation, market saturation, and subsequent decline in more recent times. A small manufacturer/dealer of car-top campers and a recreational vehicle dealer experienced similar, although less dramatic, paths. In other cases, decline resulted from innovations that rendered a product or service obsolete. On the supply side, a small manufacturing firm found itself in trouble when its raw material, a byproduct of another industry, disappeared when the latter adopted a new production process. Other sectoral changes that frequently damaged individual small business prospects arose from growing degrees of monopolization or intensification of competition in a market. The small grocery stores, for example, had to struggle much harder than previously to survive the onslaught of the large chain supermarket.

Spatial causes of business instability--the third group of factors--were most frequently attributable to neighborhood changes which worked to eliminate a local clientele or to increase business costs. One of the grocery stores in the survey had fought to stay alive even though its important customers had moved out of the area. In at least two cases, government-sponsored redevelopment projects exacerbated existing businesses' problems. Gentrification pressures that pushed up rents threaten small retailers, while higher crime rates in deteriorating neighborhoods raise insurance and security costs for others.

COMPETITIVE CONDITIONS

Traditional economic analysis often assumes that a small firm faces a competitive market of many other similarly small firms. In this situation, no single firm dominates, price competition prevails, and sellers are generally unaware of each other's behavior. Our cases, however, revealed a strikingly different picture. Most of the firms in the sample operated in markets with a substantial degree of oligopoly or monopoly in one or more of three forms. First, competition was often restricted among and between the firms directly competing in a product or service line. Second, competition was often restricted among the buyers of the goods and services the small businesses produced. Finally, competition was often restricted in the market for key supply factors such as materials, labor, building space, capital, and wholesale products for retail.

In their own markets, the firms faced varying degrees of competition from rivals. At least half of the firms responded that their competitors numbered fewer than half a dozen. Another third characterized their markets as dominated by a few large firms with many small ones like themselves operating (or trying to) in between. The degree of competition in a market seemed to be related to the stage of the product cycle, to the existence of economies of scale, and to the size of the market. Spatially limited markets are an important cause of a small number of competitors in some sectors. Over fifty percent of the firms sampled operated in markets smaller than the Bay Area and only five had a market more extensive than northern California. Many firms who might be assumed to operate in a highly competitive market (small groceries, a paint store, a dry cleaners, a liquor store) actually had few, if any, competitors because their markets were spatially circumscribed. The geographical size of their markets, however (i.e. the boundaries between their markets and competitors'), seemed to correspond roughly to economies of scale in Loschian fashion.

Since firms often operated in markets with few rivals, they tended to know who their competitors were. Several remarked that their competitors were friendly, while others reported calling competitors when looking for skilled workers. It appeared that information on supplies, prices, and products was shared as well--the construction firm, for example, shared perceptions of products, suppliers, and equipment with its rivals. Firms easily placed themselves within the pecking order in their field and responded keenly and knowledgeably to questions about competitors. Not surprisingly, firms low on the "totem pole" complained that their poor performance was due to the larger size of their competitors, while higher ranking firms prided themselves on their superior knowledge, skill, and hard work. Only one firm, an advertiser, acknowledged that its laggard performance was due to inability to match a competitors "presentation techniques."

The existence of both large and small firms in a single market seemed to indicate either product cycle evolution with growing concentration or a process of product differentiation, which is described below. While the emergence of large firms dominating a market could be expected to spell problems for smaller firms, one small grocer argued that he remains "more knowledgeable than big chain managers and more maneuverable" and was thus able to compete successfully. Product and service differentiation continues to account for the survival of small firms.

Many firms faced market power on the part of their suppliers or customers. Seven firms complained of problems arising from dependence on one or a few suppliers. A plumbing wholesaler complained that the non-price competition of his major supplier resulted in too-rapid style changes which frequently rendered his stock obsolete. A wood products firm suffered from shortages of materials available from big suppliers who, being vertically integrated, supplied themselves first during booms. The recreational vehicles dealer protested that his supplier did not innovate sufficiently to keep him competitive. The aviation-related firm resented the local airport authority's monopoly on parking space. The book dealer and the furniture dealer, both relying on limited international suppliers, complained of problems in obtaining consistent, timely and good quality products.

Six firms complained of dependence on too few customers. In some cases, these were also relatively small businesses. One customer, ironically, was a local Chamber of Commerce, which required the firm to locate in its jurisdiction in order to get its business, but subsequently stopped purchasing the service. In other cases, customers were large corporations or the government. In each instance, some aspect of unequal market power was severely affecting the small business. Oligopolistic behavior also threatened demand; for example, bank policies on lending could prevent customers from financing a purchase.

The lack of stability across the sample and the high incidence of crisis, retrenchment, or expansion cannot be ascribed solely to the business and competitive environment. Some of the problems are due to internal factors, such as management and labor practices, as we discuss below. However, the competitive conditions do seem to explain much of the success or troubles of the sample firms. Most firms carefully watch their competitors, clients, and suppliers across markets. Many are, indeed, dependent on the specific behavior of one or several of these. Although in a couple of instances, firms reported that contracts with large buyers helped them ride out recession, and while supplier credit (discussed below) was frequently a prerequisite to starting up or continuing, vulnerability to a few economic actors appeared to be a major fact and problem of small business life.

Small Business Strategies

We detected a consistent, although not universal, set of strategies that permit small firms to weather their cyclical, sectoral, spatial and competitive problems. Firms that seemed able to survive employed one of three paths, depending upon the sector they were in and the sources of their problems. We have dubbed these paths the branching, product diversification, and product differentiation strategies.

Eight of the firms, or twenty-eight percent, had or have had branches. Most could be classified as retail or consumer service-oriented--two groceries, a paint store, a dry cleaners, the recreation vehicle dealer, the health maintenance organization, the furniture dealer, and an auto engine rebuilder. All but one had four or less outlets, and two had failed or closed down at the first branching site. Branching appears to be a way for the small business experiencing neighborhood change to soften the blows of market disruption, and a way for expansion-minded entrepreneurs to overcome the growth limits imposed by a spatially-saturated market.

Product diversification was identified by ten firms, or thirty-five percent of the sample, as their strategy for cushioning themselves against cyclical, sectoral and oligopolistic conditions. This strategy included operating at different stages of product/service provision. For instance, the book firm both published its own material and distributed material for other publishers, while the trucking firm diversified into the rental business. Firms that undertook product diversification included four manufacturers, two wholesalers, and two durable goods dealers. Diversification appeared to be more common with producers and distributors than with retailers and was generally modest, in that the diversified product was closely related to the existing product and required similar business techniques and expertise. As opposed to the conglomerate pattern of diversifying into often totally unconnected products or services, the small businesses surveyed tended to keep within, and rely upon, their own specific areas of skill. Diversification was especially important to the small manufacturers as a way of riding out changes in the product cycle or coping with long-term structural changes that threaten to render their products obsolete or dry up their material sources. For distributors or durable goods sellers, diversification helped counter recessionary ups and downs, cover cash flow problems, or secure a foothold in a market.

A third strategy frequently mentioned by the firms was product differentiation. This strategy was used by firms across all the sectors that operated in markets containing large-scale or vertically-integrated firms. Small firms stayed competitive in these markets by exploiting specialized market niches, providing superior service, or servicing spatially-neglected markets. All of the grocery stores, for instance, mentioned some degree of product differentiation, such as personalized service, locational convenience, or superior quality meats. A carton-manufacturer and the car-top camper manufacturer thrived on customized service. The advertising firm exploited a specialized agricultural/mining market.

Entrepreneurial Attitudes Toward Growth and Innovation

Small firm entrepreneurs exhibited a surprising array of attitudes about the desirability of future firm growth. Because an entrepreneur's plans are frequently shaped by personal beliefs or perceptions about what is possible, generalization is difficult. Aspects of the business environment analyzed above may discourage some from trying to expand when they would otherwise like to--a parallel to the "discouraged worker" notion in employment studies. Since our interviews took place during a moderately strong recessionary period, this effect may have been more marked than usual. But of those responding to questions about future plans, approximately one third both wanted to expand and felt it likely, another third would like to grow but felt it unlikely, another third had no desire to grow. The "optimistic growers" spanned all sectors, suggesting that even in adverse market conditions a growth strategy is possible. For instance, among the three groceries, one was a satisfied non-grower, one was a discouraged grower (even though he had tried both diversity and product differentiation, his efforts could not overcome the almost total erosion of his neighborhood market), and one was an optimistic grower.

Although only twenty percent of our firms considered themselves to be in crisis situations, another forty-five percent had either resigned themselves to continual decline or faced an uncomfortably fast expansion path which they felt they had to follow to survive. Thus, on the one hand, a wholesaler/dealer remarked gloomily that "business is just good enough to keep going, but not bad enough to quit." In contrast, the manager of an expanding manufacturing firm with thirty-four employees noted that the company was too big for one person to manage, but had to grow if it were to remain competitive. Another felt he would have to accept a take-over bid soon. Some companies, it seemed, were not totally happy about their future growth even when prospects look good.

Some firms consciously chose to remain small in the face of diverse conditions and factors. A successful liquor retailer did not wish to expand or branch because of family problems. A grocer explained his "staying small" strategy in these terms: "In the supermarket business, you either have to keep on growing or stay small to survive. I've adopted the strategy of remaining small--if you're small, you don't run the risk of over-reaching yourself and making major mistakes." The decision to remain small was often associated with a risk averse attitude on the part of the entrepreneur. One retailer put it this way: "I'd rather keep the doors open at an absolute minimum than face the possibility of bankruptcy and having to close down altogether; plus, I'm too embarrassed to furnish the redevelopment agency with my financial statement." Sometimes a difference in attitude between owners and entrepreneurs could be detected. The manager of a manufacturing firm complained that his stockholders pressed him for dividends that constrained his ability to finance further expansion out of retained earnings.

The survey's findings on the degree of innovativeness of small firms were mixed. While almost none of the present entrepreneurs had started their firms with "a better idea," several of their fathers had. In each case, they had seen an unmet need that fit the demand or supply side of their current business or occupation. For instance, the advertising firm had been started by a horticulturalist who began doing PR for agricultural clients, while a wood products firm moved vertically backwards into supplying itself with an input that was scarce. However, the set of entrepreneurs in the study had also demonstrated innovativeness in diversifying their operations, mainly through product innovation. Examples were the security products firm which developed new uses for its sewing/webbing process, and the construction firm which moved into oil field pipe works. Some innovations in marketing strategies were reported--the book distributor contacted the entire array of international embassy trade delegations and stirred up more business than than he could handle.

But very few of the innovations encountered represent improvements in an existing production process. One manufacturing firm did introduce a new process which lowered labor costs by forty percent and increased employment through permitting a large expansion in the business. Another manufacturing firm invented a superior technical process for producing carpet tapes; this was also the only firm reporting an ongoing research and development effort.

The furniture dealer had an interesting "recessionary theory" of innovation. He argued that it was much easier to start an innovative new small business in the "down" business period rather than at "up" times. During boom times, companies were busy trying to serve existing accounts, could not meet existing orders for existing equipment or products, and had little spare capacity or time to entertain new ideas. But in recessionary times, companies had slack, were looking for new ideas which might increase sales or open up a new market, and were generally more receptive. He felt that now was as good a time as any to start a new small business (which he plans to do)--indeed, he felt it would be easier now than in 1949 (the year he began his now nearly defunct operation). His view is perhaps the small business counterpart to the theory of the bunching of epoch-creating innovations in the troughs of long waves.

The net result of business conditions, competitive forces, up-turns and down-turns, structural changes, and management styles is a notable volatility in business history and profitability. Although responses to queries about profits were guarded and perhaps unreliable, the average small business reported a modest profit rate of between five and ten percent. However, many experienced highly different profit levels from year to year, while others clearly were making profits quite in excess of the five-to-ten percent range. These latter tended to register low net profits because a large percentage of their profits were immediately plowed back into the business and thus appeared as equipment purchases, expansions of inventory, etc. Several firms (for example, the recreational vehicle and furniture dealers) appeared to be passing through a product cycle from high profitability in earlier years to profit squeezes or crisis conditions now. For the very small firms and proprietorships, it should be mentioned that accurately assessing profit rates, as distinct from salaries, was difficult because of the large amount of time the entrepreneurs put into their business.

LOCATIONAL HISTORIES AND PRIORITIES

The evidence on locational factors influencing small firms generally confirmed those in published research. In only three cases had entrepreneurs moved into the Bay Area from outside because they spotted a market that could be served from this location. All the rest began or bought their businesses because they lived in the area. The reasons for this have much to do with the immediate circumstances of small business formation, specifically the origins of the entrepreneurs themselves. Most entrepreneurs interviewed did not fit popular images of the "managerial type" capable of operating a business in any field or the "inventor" starting out with a better idea to exploit. On the contrary, twenty-five of the entrepreneurs started their businesses after first-hand experience in that specific <u>product</u> line--eight from family or friendship experiences; thirteen from work experience as a manager, sales person or engineer in that field; and four as workers (sometimes later rising to professional/managerial positions) for similar firms. Only two reported starting up in a completely new (to them) product line because they saw a market to exploit. Four of the entrepreneurs were "pushed" into their business when their previous employer was on the verge of bankruptcy, divestiture, closing of a particular operation or elimination of their occupation (the real estate agency, a grocery, a manufacturer and the plumbing supplier). Others were tired of working for someone else and saw a way to use their skills to branch out on their own. In general, then, most small businesses are not begun with an interregional locational choice; rather, they are spun off from already existing operations, large and small. A fair number of firms, however, had moved once or more within the Bay Area since their initial location. The factors conditioning these subsequent locational choices, in order of importance, seemed to be (1) market access, (2) adequate space at a reasonable price (typical of manufacturing, wholesaling and durable goods dealers), and (3) access to transportation facilities, especially freeways (typical of those with area-wide or larger markets). Several entrepreneurs emphasized neighborhood amenities. The furniture dealer, for instance, liked a quiet business neighborhood as well as one with mixed residential/commercial land uses which he felt cut down his security problems. The book publisher had "spiritual" needs, including the desire to escape pollution and to get as far as possible away from "neighbors." Only one firm, a larger manufacturing outfit, mentioned having to locate in proximity to worker's homes or transportation links.

Space needs varied tremendously depending upon the type of business. Desire for a larger, cheaper space was frequently cited as a reason for relocating within the Bay Area, although other firms were forced to move because their markets had shifted. Only seven of the firms owned in full or part the land and buildings they occupied. Those who did portrayed a variety of experiences with ownership. One decided to buy after having been evicted several times from previous quarters, at least twice due to redevelopment. However, others found that the illiquidity of being an owner posed long-term problems. One grocer, in a declining area, found that he was not only losing his equity in his building, but that he also could not afford to move because he was unlikely to be able to sell it at all. Furthermore, he could not even afford the operating costs of shutting down because, as the owner, he would have to pay liability insurance even if the land and buildings were unused.

Eighteen of the firms were leasees or renters of their space. These, too, had mixed experiences. Some would like to buy, but could not in an atmosphere of high interest rates and speculative land prices. Others complained of negligent landlords and of rising rents, although other firms had found good deals on rented or leased land that saved them money. The real estate agency, which sells space, felt that commercial rents were rising faster than the renter's ability to pay, which was bad business for them. Some leasing, of course, was purely formal--firms took advantage of tax breaks by setting up a sister corporation which owned the land and then leased it back.

In addition to these factors, the following hierarchy of needs with respect to capital, labor, and other factors of production also shape locational choices of small firms. Together they provide the basis for our recommendations on effective economic development tools in the final section.

RELATIVE SIGNIFICANCE OF INPUT COSTS AND AVAILABILITY

The business environment discussed in the first sections of the paper forms the greatest source of worries for small firms. Locational change, especially at the neighborhood level, often adversely affects a firm's market. But even when the demand for a firm's service or product appears stable over the near future, problems on the supply side may inhibit small firms' behavior. In our research, a clear hierarchy of supply-side problems emerged. Capital needs, both long- and short-term, topped the list. Labor requirements were only modestly problematic, while space needs (previously addressed), taxation, and government regulation were not generic issues of importance.

Start-Up Finance and Capital

Access to capital has long been cited as a major problem for small business--a claim for which our survey evidence yielded strong support. Overwhelmingly, those interviewed pointed to the difficulties in procuring short-and long-term finance as the major internal factor hampering expansion and frustrating their ability to ride out cyclical, seasonal, and sectoral changes.

Capital needs can be characterized as either long-run or short-run. Long-term credit needs include start-up money (examined in the previous section), money to replace or expand fixed physical capital (machinery, equipment, new or expanded quarters), and money to expand inventories or make an extraordinary outlay that will substantially change the business. Most of our firms' experience with long-term borrowing was limited to the start-up effort.

Start-up (or buy-out) capital came from diverse sources. The most prominent, mentioned in at least twenty-three cases, was personal savings. For many, this was the sole source of start-up capital. Five reported help from friends and parents as well. Only one had outside investors beyond personal connections. Five firms, mainly distributors, dealers and retailers, cited supplier credit and advances of inventory. Four were extended credit by previous owners of the business who wanted to sell. One entrepreneur reported that customer credit helped him start up, one used a government loan (the health maintenance organization), and one (the book publisher/distributor) started with his own volunteer labor, living off his wife's paycheck. In some cases, entrepreneurs went to extraordinary lengths to start up their business. One entrepreneur took out a $1500 loan from a household finance company (at an annual interest rate of nearly thirty percent), one used his car and personal tools for collateral, another his furniture for the same purpose, while yet another took out a second mortgage on his home.

Six firms reported borrowing part of their start-up capital from banks. While this represents a minority (thus supporting small businesses' claims that banks will not generally finance business start-up) it does suggest that bank capital is possible. However, in almost all cases, the willingness of banks to lend at this stage depended upon either a relationship with a large well-known corporation (such as a supplier or previous owner) or the security of a type of collateral which the bank would find liquid if it were forced to foreclose, i.e., trucks, buildings, aircraft, real estate or recreational vehicles. Several of our firms expressed a willingness to borrow long-term but were very pessimistic about bank receptivity.

Many firms resorted to short-term borrowing to survive cash shortages that arose from supply rigidities, mismatches between payments and receipts schedules, and laggard accounts receivable. Nineteen of the firms--over two thirds--stated that short-term cash needs were a serious problem. Two health service firms cited slow government reimbursement for patient services as a problem; a construction firm serving public sector clients also complained of unduly slow payment. Some sell to other small businesses who in turn have difficulty paying quickly. Both recession and inflation exacerbate cash flow problems--the first by increasing the magnitude of the problem and the second by raising the interest rates due on short-term loans.

About one third of our firms stated that they had never borrowed a cent since opening. Some of them were adamantly and ideologically opposed to borrowing. "The problem with loans is you gotta pay them back," was the succinct comment of a successful engine rebuilder with several branches. Others would borrow but could not find a reasonable source. For those that did borrow interest costs ran quite high--one dealership reported that bank interest on his durables stocks ran to forty percent of his costs. Of those using banks, a handful had succeeded in establishing a credit line, while others obtained intermittent loans for short-and long-term purposes. About four of the firms dealt with small banks. The six who borrowed from the big California banks felt that their creditworthiness was due to their track records (the case with branching efforts), their links with a large silent business partner (the security equipment firm), or the salability of their assets if their businesses should fail. Smaller banks were more apt to lend on longstanding personal relationships or on personal assets (a house, life insurance).

Not all borrowing took place with banks. At least nine firms received or currently used supplier credit. In some cases, firms who could not get supplier credit in the initial period have been able to get it subsequently through establishing a good track record. Supplier credit, however, generally came along with uncomfortably close control or scrutiny by the supplying corporation, and sometimes at a high interest cost. An example was the aviation dealer, who was forced to absorb overproduced inventory in the downswing and pay substantial interest on equipment not sold within ninety days. Food markets, on the other hand, had relatively amiable and less costly consignment arrangements.

The firms sampled exhibited a remarkable array of techniques for coping with short term cash flow problems without resorting to suppliers or bank credit. Some adjusted input costs to changes in the business or product cycle or seasonality. The recreation vehicle dealer cut both inventory and labor in response to market saturation and the recession, while the packaging manufacturer drew down his inventory to accommodate insufficient demand. A small advertising firm used voluntary reductions in staff salaries to solve cash flow problems, with repayment plus bonuses promised in better times. Others adjusted their business payment and charge practices to handle cash flow difficulties. The florist cited his decision to accept credit cards as an antidote to accumulated accounts payable, despite the extra cost to himself. Two firms initiated interest charges on their accounts receivable. One firm, the furniture dealer, engaged in factoring accounts receivable, i.e., selling them to a collection agency. The plumbing supplier had decided to routinely charge other small businesses higher prices than his larger clients, because the former so frequently stretched out their payments when the business cycle depressed construction activity. Several firms reported stretching out their own payments to creditors, and in one case, squeezing customers, as unpleasant but necessary ways of coping with cash flow crises.

For longer-term capital needs, firms sometimes resorted to structural changes in their form of operations. The Health Maintenance Organization (HMO) reported that many cash-strapped HMOs were merging with large insurance companies that were cash-heavy. However, retained earnings were the most common source of long-term capital for expansion or equipment replacement purposes. Many of the firms relied solely or largely upon retained earnings. It seems reasonable to conclude that the scarcity of longer-term finance and the dependence on retained earnings lead small businesses to be undercapitalized on the whole.

Labor Costs and Related Issues

Employment generation is one of the principal reasons for public interest in small businesses. The literature tends to assume that small businesses are characterized by low-wage, relatively unskilled jobs with high turnover rates, by hiring problems, by extensive use of part-time labor, by high degrees of occupational segregation by race, age and sex, and by significant opposition to unionization. Our survey results contradicted many of these notions.

First, a large number of the jobs in the small businesses surveyed could be classified as skilled. These tended to be concentrated in the manufacturing, construction, and finance/insurance/real estate categories. Employers did not generally encounter difficulties in filling skilled job positions. Second, three out of four were willing to do some on-the-job-training. In a couple of cases, community college and technical school programs helped provide well-trained workers, and one or two had used government employment programs.

Third, a large majority of firms reported no turnover problem. Many of these had very low turnover rates, while others found no difficulty in replacing workers who had left. Of four reporting problems, three of these offered low-wage jobs with relatively undesirable working conditions. Confirming that neither labor shortages nor high turnover rates constituted a serious problem, almost all of the firms relied upon word-of-mouth recruitment. Drop-in job seekers provided a second source of new workers, and the State Employment Service yet another. Very few firms advertised jobs, and only one had used a private employment service.

The survey did uncover isolated cases of high turnover rates. One firm reported that its skilled workers, after learning and enhancing their skills on the job, frequently took advantage of opportunities to move on, often to competitors. A manufacturer prevented this problem from developing by deliberately limiting the skills his workers learned on the job. On the other hand, in some smaller firms (with less than ten employees), most of the workers mastered all of the business's operations and were thus highly valued by the management. One entrepreneur paid "top dollar" to his workers to induce them to stay.

Several small firms found that hiring the right person for the job was often difficult. This did not necessarily reflect a lack of qualified candidates, but rather the combined effect of an inability to gauge workers' skills accurately beforehand and a reluctance to fire them subsequently. A mistake in hiring can be especially costly for a small firm. One employer hired a mechanic who had misrepresented his familiarity with diesel systems and had ruined a rig.

Fourth, a large number of firms offered full-time employment. Those who did offer part-time work did so because of the peculiar nature of their businesses, not in order to avoid paying benefits or meeting regulations. A decline in business, for instance, resulted in a firm (e.g., the furniture dealer) putting workers on a shorter work week, which was seen as more equitable (as well as more profitable) than firing. Alternatively, the advertising firm dealt with stagnation by eliminating artists' positions and contracting out to free-lancers. A manufacturing firm, a real estate agency and a distributor all found it advantageous to use salespeople outside the firm's payroll to avoid carrying them in bad times. Seasonal ups and downs were occasionally met with by part-time help. And the time-specific services, such as restaurant meals, tended to employ part-time help. Nevertheless, most firms in the sample employed full-time workers with benefits as well as regular wage and salary commitments.

Fifth, findings on occupational segregation were mixed. Six entrepreneurs were proud of the level of racial and sexual integration of their workforces, although it was impossible to determine in all cases whether men and women, black, Chicanos, and whites were actually working in the same occupations with the same wage levels. Seven firms were clearly highly segregated both racially and sexually. Seven firms reported a racially-integrated workforce that was either heavily male (six) or heavily female, (one--a manufacturing firm with sewing operations). Only two firms exhibited gender integration but racial segregation. Summing up the categories, almost fifty percent of establishments were clearly racially segregated while nearly seventy percent were sexually segregated. Age segregation was difficult to detect--some firms hired in very limited age categories, while others reported workers of all age levels. Generalizations by sector and size were also difficult to make, although the smaller and/or more professional service-oriented firms seemed most apt to have integrated workforces. Examples were two groceries, a real estate firm, the securities investment company, and the Health Maintenance Organization.)

Sixth, compensation rates were on the average substantially above the minimum wage. Wage levels among the firms were almost never reported to be below five dollars per hour. Manufacturing firms tended to be on the high side; a wage of five or six dollars an hour characterized entry levels, and only one paid just minimum wage. Relatively high wage levels do not appear to reflect shortages of prospective employees, but rather productivity, a relatively low labor content in several firms, a desire to keep out unions, and in a number of cases a desire to reward and keep able employees. Two firms planned to institute profit-sharing for their employees.

Unionization was not uncommon across the sample. Eight firms reported that some or all of their workers were unionized. These included all three groceries, a manufacturer, a construction firm, the Health Maintenance Organization, the plumbing dealer, and the restaurant. Most of these firms had no major quarrels with the union. Several used a union hiring hall for recruiting. One adamantly refused to hire from within the union but would permit his new employees to join; he was also the only employer reporting a past incidence of violence during an employee's strike. Fourteen of the firms had no union nor had experienced attempts to organize. Some went to great lengths to create personable relationships with their workers designed, at least in part, to preempt unionization drives; others paid higher-than-union-scale wages and benefits to achieve the same end. One firm "got rid" of a union, while two others successfully blocked unionization efforts. The antagonism of certain employers towards unions arose from fear of a loss of control over the work process, rather than higher labor costs. Some entrepreneurs were frank about wanting to maintain strict control over their operations and strenuously objected to unions. In a couple of cases, managers argued that unionization would hamper the "willingness to work."

Public Sector Taxes and Regulation

The debate on small business incentives often pinpoints government "red tape" and excessive taxation as major impediments to survival. Our findings suggest that this problem has been overstated. These small businesses were less encumbered with taxes and (especially) regulation than is popularly suggested.

Of those firms responding directly, eight stated that tax levels were not particularly problematic for them, while only three complained about high taxes. Five others said that while tax levels were not a problem, the paperwork associated with filing was. Still others cited one particular tax or another as problematic--three cited the payroll tax, two the tax treatment of inventories, three the sales tax, one the proposed unitary tax, and one the unemployment insurance tax. For example, a retailer resented the sales tax being imposed on his purchases, but not his sales. One owner lamented that he had not properly understood the proper procedures for charging sales tax. He had consistently not assessed it on a particular service item but then had to pay the back taxes on discovery. This entrepreneur argued that small businesses ought to receive better educational assistance from the government on their tax liabilities.

Small firms held divergent views of the favoritism of the tax system with respect to size. The restaurateur complained that small business did not get any tax breaks, while another complained that "small businesses received no incentives to accumulate, nor to engage in research and development." On the other hand, some firms seemed to think they received a relatively fair deal. The book distributor was thankful that imported books were not taxed. The high incidence of professional accountants preparing tax returns suggests that many do take investment tax credits and accelerated depreciation allowances. Partnerships and proprietorships take advantage of loopholes that permit the write-off of personal expenses as business costs.

Nor was there much consensus about excessive regulation. Only three firms claimed that regulation in general posed difficult problems for small businesses. At least six firms stated that regulation was not at all a problem. And, despite the publicity they have received, neither OSHA nor environmental regulations were mentioned by more than three firms each. Four firms (the advertiser, the paint store, the trunk rental firm, and the tool sales distributor) said that their small size either helped them avoid adverse regulations or led to positive benefits from regulatory rules. Several firms found regulations cumbersome or costly but were willing to admit the real need for them, especially those which concern worker's health and safety or unemployment insurance.

Those firms complaining of regulatory ills generally had one enterprise-specific complaint. Two, for instance, found new energy regulations to be problematic. One, the small securities investment firm, had difficulty meeting all the SEC regulations. The construction firm resented minority contracting requirements. Two firms complained about heavy bonding requirements on large government contracts. One resented petroleum products anti-pollution measures; another disliked consumer product inspection. One grumbled about returnable bottles, another about liquor laws, another about unit pricing of groceries, while one grocer resented becoming an enforcement officer for the food stamp program. Many of these were not new regulations, and in most cases they were merely annoying, not crippling the firm.

In only a couple of cases did specific regulations pose serious problems. The real estate agency felt it would soon have to treat its agents as employees, resulting in large increases in social security and other payroll-related costs. In two cases, government-sponsored redevelopment activity had displaced businesses or severely crowded their markets. And, as we noted above, government tardiness in paying for health benefits posed large problems for two firms. But these examples are not, properly speaking, "regulatory" ones.

Only one entrepreneur talked about engaging in illegal behavior in response to public sector problems. "Government tax and regulation makes a person act illegally," he stated bluntly. He said that in his firm, it was possible to get around taxes by shortening inventory and underreporting sales (upon which sales tax had already been charged).

CONCLUSION

Our findings can be summarized briefly. First, the business environment of the sampled firms was quite turbulent, subject to seasonal, cyclical, spatial, and sectoral fluctuations of substantial magnitude. Particularly damaging were setbacks associated with rising costs, recession-related declines in sales, and market saturation at later stages of the product cycle. Many of the small businesses operated in markets dominated by large firms or depended on a few major suppliers or customers. These firms were quite vulnerable to changes in the business behavior of such larger firms. The strategies most often used by the small firms to deal with business environment and competitive problems included branching, product or service diversification and product differentiation.

Second, sampled firms generally located in the Bay Area because their entrepreneurs live here. A large number of them did change their business location within the area subsequently. Market access, adequate space, and access to transportation links appeared to be the most important determinants of present locations.

Third, finance capital posed a major problem for the firms, in both the long and the short run. Personal resources provided the sole or main source of initial capitalization. Only those firms with special connections or salable assets seemed able to secure bank credit. Cash-flow problems were severe for over two-thirds of the businesses in the sample. Neither shortages of skilled and unskilled labor nor turnover rates posed major problems for the majority of the firms. Wage levels were not frequently cited as a deterrent to employment expansion. Unions were present in less than one-third of the firms, and only firms in the manufacturing sector expressed strong opposition to unionization. Tax and regulatory problems posed fewer difficulties than business environment or capital access issues.

A survey such as this is useful for generating ideas and directions of work, rather than providing statistically valid results. Nonetheless, it does suggest some conclusions for research and policy. The theoretical grounding for small business research and policy needs to take into account the characteristics and the diversity that were evident even in this limited sample. Thus, the quasi-oligopolistic nature of small business competition, which is intimately associated with its localized character, indicates that an adequate theory of small business behavior should not asssume perfect competition. In addition, the diversity in age of firm and business objectives suggest that we need to construct a more articulated model of the role of small business in urban structure. It seems to us that small businesses are clearly playing very different roles that range from community stabilization to providing vehicles for development and change.

For policy, a first conclusion is that we should be cautious in listening to advocates of specific proposals intended to enhance small business performance. The individual circumstances of small firms are extraordinarily diverse, and proposals favoring one group may well injure others. Nevertheless, the survey results do support some directions of policy. Capital constraints emerged here, as elsewhere, as the single most pressing problem. The forms of constraint, however, depend greatly on firms' individual situations. For example, lower taxes on reinvested profits will not help a firm caught in a cyclical squeeze on operating capital. The purposes of policy in this area need to be clearly defined. Similarly, the assumption that regulatory policy is oppressive to small business needs to be reexamined.

The observation that firms play very different roles in the urban fabric also suggests some possibilities for policy. Neighborhood conservation and revitalization programs should be designed to include a careful assessment of the needs and vulnerabilities of small businesses, and to provide explicit assistance if necessary. Economic development policy on a local level is likely to be far more effective if it recognizes the multiple roles of small business and attempts to respond to them.

Overall, we conclude that a stronger grounding in understanding of the real nature and diversity of small business is necessary for improved theory and policy alike. Characterization of this enormous and richly complex segment of the economy and society by a simple criterion of size is simply inadequate.

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