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THE EFFECTIVE UTILIZATION OF SMALL BUSINESSES TO PROMOTE ECONOMIC GROWTH

HEARING

BEFORE THE

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

NINETY-SIXTH CONGRESS

FIRST SESSION

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THURSDAY, OCTOBER 25, 1979

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to notice, at 10:05 a.m., in room 210, Cannon House Office Building, Hon. Parren J. Mitchell (member of the committee) presiding.

Present: Representative Mitchell.

Also present: David W. Allen, M. Catherine Miller, and Deborah Norelli Matz, professional staff members; Mark Borchelt, administrative assistant; Katie MacArthur, press assistant; and Mark R. Policinski and Carol A. Corcoran, minority professional staff members.

OPENING STATEMENT OF REPRESENTATIVE MITCHELL, PRESIDING

Representative MITCHELL. This hearing will now come to order.

Today we shall hold hearings to address the issue of small businesses in the economy. The concern of this particular member is the efficiency of small businesses and their potential impact on the economy. At issue is whether a more viable small business sector could serve to address the macroeconomic problems of reductions in productivity levels, increases in inflation due to shortages and inefficiencies on the supply side of the market, rampant growth in the structurally unemployed due to regional and occupational shifts, and large trade deficits.

We have initiated these hearings with the long-range goal of investigating the possibilities of more targeted Federal procurement in tax expenditure policy, which could serve to facilitate small business growth in the economy.

Today we have three expert witnesses who have come to share their knowledge of small business. With us today is Mr. Milton Stewart, Chief Counsel for Advocacy, Small Business Administration, who will discuss small business and the potential of the small business sector in regional growth. Mr. David Birch of the Massachusetts Institute of Technology will discuss the employment-generating capabilities of the small business sector. And Mr. John Rennie, chairman of the Smaller Business Association of New England, International Trade Committee, will discuss the small business potential in addressing the problems of a balance of trade deficit.

There are one or two routine announcements that I would like to make before we hear from the witnesses. First of all, you see that we are now in session, unfortunately, this morning. My assumption is that for the next half hour or so, the House will be regaled with 1-minute speeches covering a variety of subjects ranging from the powers of a stud bull to some macroeconomic theory.

Shortly thereafter, I would suspect that I would have to adjourn the hearings briefly to run over and record my presence before we get into today's business.

So if we have three bells or two bells, you will forgive me if I suspend at that point. It only takes me 7 minutes to get to the Capitol and back.

The second announcement that I wanted to make is that I'm very delighted to have with us five gentlemen who are law students at the law school of the University of Virginia.

I was down there a few short months ago to speak to the law school students. These gentlemen and others evidenced a great deal of interest in government and the efficiency and skill of the Congress of the United States. They came to witness the efficiency and skill of the Congress of the United States.

Gentlemen, we're delighted and we hope that we will not disappoint you too much.

The third brief announcement is that I'm very pleased to note that when the House acted on the Department of Energy bill, indeed, we managed to get through a set-aside for small business.

The House mandated a 12-percent set-aside for small business in the Department of Energy bill. I think that's most encouraging because, in my opinion, small and minority businesses, or small and disadvantaged businesses have simply not gotten their share of much of the Federal dollars that are being spent.

With that background, and you've been introduced, gentlemen, I would suggest that we proceed. I think the most felicitous way of proceeding would be to get the statements from all of you, then we'll go into questions.

The Congress does not have arbitrary powers, and I would suggest that the experts designate the leadoff witness themselves.

Mr. Stewart. Representative Mitchell, I would like, with your permission, to offer my prepared statement for the record at this point and to express the conviction that I've had for many years about Members of Congress—they know how to read and, therefore, I will summarize it very briefly, if I may.

Representative Mitchell. Without objection, your prepared statement will be entered in its entirety into the record. The Chair does have some concerns about the reading capability of all the Members of Congress, but I'm happy to hear what you've said. [Laughter.]

Please proceed.

STATEMENT OF MILTON D. STEWART, CHIEF COUNSEL FOR ADVOCACY, SMALL BUSINESS ADMINISTRATION, WASHINGTON, D.C.

Mr. Stewart. Thank you. What we, in Advocacy, have tried to summarize in our prepared statement are some of the structural matters that concern the ability of small business to make its contribution in the economy.

We have given you some data indicating the order of importance which small business itself assigns to various national problems that confront it, beginning with taxes, inflation, and so forth.

We've given you some data showing the relative debt and equity in the financial structures of small and large firms to indicate the greater vulnerability of small business to changes in the economy. And, we've indicated the same data for manufacturing corporations over a period of time to show some fluctuation. Included is a chart captioned "Small Business: the Nation's Job Maker." This is limited to those jobs which are covered by social security. What it reflects is that small business, if you define it as enterprises with 500 or fewer employees, employs three-fourths of the private sector labor force.

We have, in our discussion, focused on the greater ability of small business—I'm sure that Mr. Birch will touch on this at some length—to add jobs to the labor force. We've contrasted the contribution of the Fortune 1,000 largest industrial firms which created about 75,000 jobs in 8 years with the contribution of the small business sector of some 5½ million jobs.

And we've referred to some data that is just now coming in from our regional research project which indicates that the greater small business job-creating proclivity exists there, too.

And we've included some well-known data on the greater capacity of young, innovative high-technology firms to create jobs than those which are older and larger.

The prepared statement includes a discussion of productivity, with particular reference to the ability of small business to add to it, and the limited ability of small business, compared to large business, to add to its own productivity in the areas of innovation, because of patent restrictions, regulatory restrictions, and the unequal burden of Government regulation.

In table 4 of my prepared statement, we've given you some data about taxes and, frankly, Congressman, I wish every Member of Congress had it at his fingertips, because what it establishes is the rather extreme regressivity of the total tax burden per dollar of net worth for corporations in manufacturing in the United States.

The table also shows that, compared with the largest businesses in the country, which paid 14 cents of every dollar of net worth for taxes in 1978, the family-size businesses which we've defined here paid 66 cents. And the progression from the heaviest burden on the smallest back to the lightest burden on the biggest back goes up through every size of business enterprise.

Let me say, at this point, that we in Advocacy are committed to overcoming the disparities of small business and its ability to contribute to the Nation's economy, and were particularly pleased with the action of the Congress in the last session of establishing the first graduated system of corporate rates for firms with under $100,000 in pretax earnings.

We've concluded our prepared statement with this general proposition: That instead of helping small business, Government is creating artificial economies of scale which provide an undue competitive edge to large business.

In other words, by the alleged equal treatment of large and small business, for example, with respect to regulations, we're actually burdening small business more and limiting its ability to compete with large business.

Advocacy's goal is to reverse these trends in cooperation with the private sector and a number of other agencies.

In summary, we say that there's a growing body of evidence to suggest that small business, particularly the high-technology, innovative company, is one of the keys to solving the structural problem facing the United States.

In conclusion, Congressman, we're obviously talking about matters that are very deep seated, that have both immediate short-term crisis significances, like credit shortages that are upcoming because of what the Fed has done just recently, as well as very long-term ones, like the fact that we have 25 million poor people whose productivity contribution to the total economy is not what it should be, and whose productivity contribution can be best enhanced, in our view, by expanding the small business sector. Because I think, as Mr. Birch will illustrate, it is the small business sector which creates entry-level jobs in this country.

Very often, Federal programs have been mistargeted. The classic example is the CETA program, which has tried in the private sector to focus on large companies where there are not the jobs for the country's relatively unskilled, poorer people.

Small business has those jobs. We have the anomaly in city after city of small business people saying that they can't find employees, and poor people saying that they can't find jobs, because we haven't succeeded in fitting them to one another yet.

Thank you, Congressman Mitchell.

[The prepared statement of Mr. Stewart follows:]

Prepared Statement of Milton D. Stewart

Mr. Chairman and members of this committee, it is a pleasure for me to appear before you and to discuss the importance of small business involving the structural problems that are facing the United States today. First, let us define what are the basic structural problems. If you poll a group of economists you would get the following list: inflation, unemployment, inadequate growth, declining productivity, and perhaps a basic imbalance in our foreign trade. If you ask a group of small businessmen what were the basic structural problems facing them, they would probably come up with a list like this: inflation, taxes, government regulations, and competition from large business. (See table 1 for more details.)

TABLE 1.—QUESTION: WHAT IS THE SINGLE MOST IMPORTANT PROBLEM FACING YOUR BUSINESS TODAY?

	1978								1979			
	January		April		July		October		January		April	
Most important problem	Rank	Percent	Rank	Percent	Rank	Percent	Rank	Percent	Rank	Percent	Rank	Percent
Taxes	2	22	2	20	2	21	2	18	2	15	2	16
Inflation	1	25	1	32	1	33	1	34	1	36	1	36
Inadequate demand for product	8	4	8	3	8	2	7	2	8	2	8	2
Interest rates and financing	7	5	7	5	5	7	6	7	3	11	3	10
Minimum wage laws, cost of labor	4	8	6	7	5	7	6	7	5	7	6	6
Other government regulations, red tape	3	12	3	11	3	10	3	10	4	9	4	8
Competition from large business	4	8	4	8	7	6	4	8	5	7	6	6
Quality of labor	6	7	4	8	4	8	4	8	5	7	4	8
Shortage of fuels, materials or goods	9	1	9	1	9	1	8	1	9	1	7	3
Other; no answer		8		5		5		5		5		5
Total		100		100		100		100		100		100

Source: NFIB, Quarterly Economic Report For Small Business, July 1979.

It is my opinion that the growth of small business can be an important part of the solution to our basic structural problems. Small business people believe that their ability to help solve these problems are sharply and needlessly limited by government policies at all levels.

The President is already leading the fight. His effort to balance the Federal budget as soon as possible, to hold down wages and prices, to cushion the impact of the energy problems and to ease the regulatory burden are notable.

INFLATION

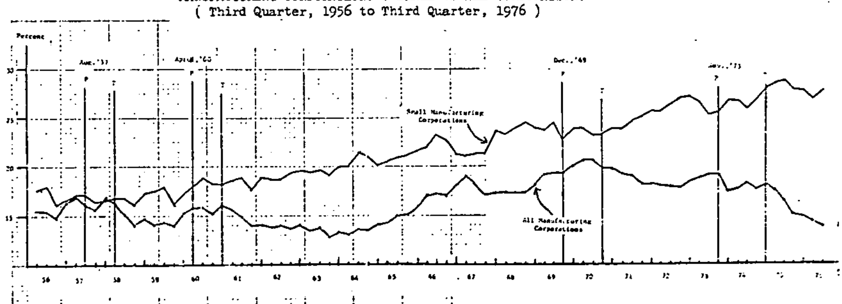
Some economists feel that much of our current inflation is of the cost-push variety. Too much market power in large businesses and large unions dull the cutting edge of competition. Clearly, small business can help counter this source of inflation. It is the innovative entrepreneur who develops a new product, like the mini-computer, and finds his niche in the oligopolistic market. There he can successfully compete both on a quality and price basis. His new innovation generates a new set of competitors.

But because the small firm has a serious problem in obtaining expansion capital to allow him to successfully compete with larger firms, the most successful of the small competitors tend to sell out to large business as a way of getting the necessary funds. The corporate structure allows large business to accumulate tremendous cash flows that are available for investment purposes. Thus the large firms get larger by buying out small firms. Unfortunately, when the small firm becomes part of the large conglomerate, it tends to lose its ability to respond quickly to changes in the market. It is less willing to take the risk necessary for new innovations. We need new policy initiatives to discourage the acquisition of small firms by large conglomerates. Thus, one of the solutions to cost-push inflation is a more dynamic small business sector. One key to that is the prevention of mergers by "government size" businesses.

Inflation makes small business less competitive and this is why small business people list inflation as their number one problem today. As table 2 shows, small business has a higher debt-equity ratio. A larger share of this debt is in short-term commercial bank credit. (See figure 1.) As inflationary expectations increase, forcing interest rates up, the costs of the small firms rises by more than its large competitors; that is, interest costs are a larger portion of small firms costs. The more rapid the inflation and the higher rates go, the greater the competitive disadvantage of the smaller firm.

FIGURE 1

RATIOS OF INDEBTEDNESS TO BANKS AND TOTAL INDEBTEDNESS OF MANUFACTURING CORPORATIONS : SMALL VS ALL CORPORATIONS
(Third Quarter, 1956 to Third Quarter, 1976)



Note: P and T for business cycle peaks and troughs. Tight money period of 1966-67 is not indicated.
Source: Ratios computed from FTC, Quarterly Financial Reports.

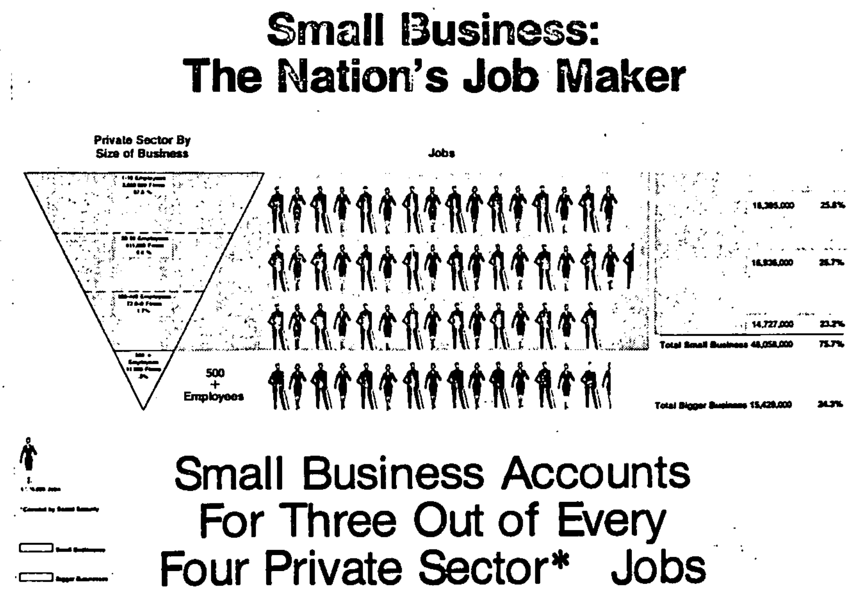
A tight monetary policy means interest costs increase even more, but it also means less credit is available. Small business, along with local government and consumers, tend to be the first who are squeezed out of the credit market. The unavailability of necessary inventory financing and working capital is a thing which causes many small business failures during periods of tight money policy. Consequently, controlling inflation with monetary policy gives large business a competitive advantage since they are less dependent upon bank credit for their financial needs.

UNEMPLOYMENT

As Dave Birch at MIT has shown, using the individual records from the Dun & Bradstreet files from the period of 1969 to 1976, establishments with 0 to 20 employees created 66 percent of private sector employment. Establishments with 21 to 50 employees in size created 11 percent of private sector employment. Thus, smaller sized firms generated 77 percent of the employment growth for our economy. Medium and large business (those with 500 employees or more) created only 13 percent of private sector employment.

There are many complaints about the quality of Dun & Bradstreet's data base. But, using aggregate employment statistics, we have come up with very similar results showing that small business accounts for three out of every four jobs in the private sector covered by Social Security. This information is shown in figure 2.

FIGURE 2



Another way of approaching the job creation potential of small business is to look at the job generation statistics of the Fortune 1,000. In the period from 1969 to 1976, the Fortune 500 increased their employment by less than 1 percent (.15 percent); the second 500 increased employment by 2.8 percent. Thus, the Fortune 1,000 created something like 75,000 jobs during the period when the total increase in the labor force was some 14 million. (See table 3.)

TABLE 3.—EMPLOYMENT OF THE FORTUNE 500 AND TOTAL U.S. CIVILIAN LABOR FORCE

Year	1st 500	2d 500	Civilian labor force
1976	14, 836, 163	1, 874, 614	94, 773, 000
1975	14, 412, 992	1, 861, 352	92, 613, 000
1974	15, 255, 946	1, 993, 976	91, 011, 000
1973	15, 631, 683	1, 966, 814	88, 714, 000
1972	14, 676, 849	1, 845, 502	86, 542, 000
1971	14, 324, 890	1, 765, 418	84, 113, 000
1970	14, 607, 581	1, 719, 805	82, 715, 000
1969	14, 813, 809	1, 822, 071	80, 734, 000
Total increase	22, 354	52, 543	14, 039, 000
Total percent increase	0. 15	2. 8	14. 8
Average annual percent increase	0. 02	0. 42	2. 3

Note: From 1969 to 1976, total employment increased by 9,583,000. 99 percent of employment occured in firms other than Fortune 1000.

Sources: Data for the 1st and 2d 500 are published yearly for the previous year in Fortune Magazine, in May and June, respectively. Data for the total civilian labor force was obtained from the 1978 Economic Report of the President.

A recent paper by Randall Eberts of the University of Oregon, which is a part of our ten volume series on "Environment for Small Business and Entrepreneurship," is relevant here. Two major findings emerged. The first is obtained from examing the size distribution firms. The results show that medium size firms within a range of roughly 60 to 140 employees are most likely to grow due to the rapid adoption of innovations or by recent mergers and acquisitions. However, it is also shown that the medium size firms do not promote regional growth. In fact, they appear to deter growth. The presence of smaller firms with less than 20 employees, on the other hand, are shown to enhance the growth of a region.

The key to employment growth appears to be the innovative entrepreneur who establishes a new firm to market his invention. The role of small innovative businesses of this type in stimulating economic growth can be seen in the following two studies. The first, by Massachusetts Institute of Technology Development Foundation, shows compounded average annual growth rates from 1969 to 1974 for the following three groups of companies.

[In percent]

	Sales	Jobs	Taxes
Mature companies	11. 4	0. 6	7. 8
Innovative companies	13. 2	4. 3	8. 5
Young, high-technology companies	42. 5	40. 7	34. 1

The MIT report states, "It is worth noting that during the 5-year period, the six mature companies with combined sales of $36 billion in 1974 experienced a new gain of only 25,000 jobs, whereas the five young, high-technology companies with combined sales of only $857 million had a net increase in employment of almost 35,000 jobs. The five innovative companies, with combined sales of $21 billion during the same period, created 106,000 jobs." Conclusions similar to those mentioned above emerged from a study of 269 firms by the American Electronic Association. In February 1978, Dr. Edwin V. Zschau of the AEA presented the results of that study to the Senate Select Committee on Small Business. The report showed the following growth of employment for new established firms as contrasted to more mature companies:

	Stage of development	Employment growth rates in 1976 (percent)
Years since founding:		
20 and over	Mature	0.5
10 to 20	Teenage	17.4
5 to 10	Developing	27.4
15	Startup	57.7

Zschau also reported that annual benefits to the economy realized in 1976 for each $100 of equity capital that had been invested in the start-up companies founded between 1971 and 1975 were: foreign sales—$70 per year; personal income taxes—$15 per year; Federal corporate taxes—$15 per year; state and local taxes 0–$5 per year; total taxes—$35 per year.

This data shows that the benefits of investing in small innovative ventures are large. This large and powerful flow of benefits starts soon after the investment is made, and the benefits are substantially greater than those of large corporations.

Another study from our regional reports, this time from Region IX, (O. J. Krasner and N. L. Dobrow, "The Role of Small Business in Research and Development, Technology Change and Innovation in Region IX") shows that the "borrowing problem is the most serious problem in the start-up period for innovative high-technology companies and through the first years of operation. After the firm reaches a more mature position, credit needs change to just an "irritating" problem. Our hearings on small business and innovation also presented evidence that many innovations never get to market because of a lack of venture capital. Thus, increasing the availability of capital and credit to the innovative firms appears to be the best way of releasing the employment potential of small businesses.

PRODUCTIVITY

How rapidly output per unit of labor changes depends upon how rapidly the idea of the inventor becomes an innovation and how rapidly innovations are diffused throughout the industry. I am convinced that this process is dependent upon whether the entrepreneurial risk-takers in our economy can raise enough money to convert new ideas into new products. But, the tax system must reward these risk-takers for their efforts when they are successful. Federal, State, and local governments' regulations and paperwork must not be allowed to stifle their innovative zeal. If we can unleash the innovative spirit, the rate of diffusion will depend on competition which forces other firms in the industry, both large and small, to adopt the new innovation or be forced out of business. As I view things, the present structure of our economy greatly inhibits the innovative process.

First, our tax structure leaves the largest cash flow, not to the innovative entrepreneur, but to the large firm. Evidence indicates that the larger firm is least productive of innovations. The large firm uses less of its cash flow to innovate and invest in new plants and equipment because they are too risky. Instead, they buy up the successful small firms, usually removing the dynamic entrepreneur from the scene, replacing him with the bureaucracy that is inherent in any large business or conglomerate. Evidence to support this notion has appeared in other hearings. Let me just review some of the most interesting results.

TABLE 2.—CORPORATE DEBT-EQUITY RATIOS FOR SELECTED INDUSTRIES FOR FIRMS WITH NET INCOME, BY ASSET CLASS, 1976

[Asset classes (thousands)]

	Under $25	$25 to $50	$50 to $100	$100 to $250	$250 to $500	$500 to $1,000	$1,000 to $2,500	$2,500 to $10,000	$10,000 to $25,000	$25,000 to $100,000	Over $100,000
Manufacturing	2.99	1.36	0.94	0.47	0.59	0.59	0.51	0.45	0.40	0.45	0.57
Services	1.07	.72	.91	.85	1.18	1.74	2.11	2.07	1.39	1.14	1.25
Construction	2.00	1.25	1.35	.92	.98	1.13	1.11	1.21	1.24	1.08	.78
Transportation	1.04	1.22	1.18	1.21	1.03	1.11	1.25	1.20	.96	1.17	.99
Wholesale and retail trade	2.52	1.06	.77	.76	.79	.91	.90	.91	.79	.73	.72

Source: Office of the Secretary of the Treasury, Office of Tax analysis, Oct. 4, 1979.

A recent study by the National Science Foundation concluded that in the post World War II period, firms with less than 1,000 employees were responsible for half of the "most significant new industrial products and processes." Firms with 100 or fewer employees produced 24 percent of such innovations. In addition, the cost per innovation in the small firms was found to be less than in the large firms since small firms produced 24 times more major innovations per research and development dollar expended as did large firms. Yet, small firms receive less than 4 percent of U.S. research and development dollars. While there is much innovation that can only occur in large resourceful companies, small firms are often more adventuresome and have a greater propensity for risk-taking and accordingly, are able to move faster and use resources more effectively than large companies.

In the region IX paper by Krasner and Dubrow, which I mentioned earlier, comes the following quote: "Large organizations are more likely to be the sources of 'process' innovations, and where they do develop new products these products are likely to be incremental improvements. Small businesses, on the other hand, are likely to strive for and often achieve "leapfrog" product innovations. Larger organizations are likely to experience personnel displacement as improvements are made to methods and jobs; small organizations are more likely to create new job opportunities and occupational specialties * * *.

"The patent data investigated by Schmookler indicate that as many as 50 percent to 60 percent of today's inventors are outside of the organized research groups of the corporate industrial laboratories. Independent inventors took out roughly 40 percent of the total patents in the United States. At the same time, it appears that of the 60 percent issued to corporations, one-third came from corporation employees working outside of the laboratories.

"Further, it may or may not be significant that 75 percent of the patents issued to small companies are commercially used, compared to 50 percent use rate issued to large companies. It appears than that the bulk of the measured inventive activities orginates in the work of independent and small and medium size firms.

"Yet these sources have, until recently, been relatively neglected and their potential contributions virtually ignored; the laboratories of the large industrial corporations have been receiving most of the support."

And how easy do we make it for the entrepreneur to generate new capital for his new ideas? Table 4 shows the effective tax rates per dollar of net worth in manufacturing. Note that the new small firms appear to have an effective tax rate 4.7 times the large firms; that is, the family size small business has total taxes per dollar of net worth of 66 cents while large business has total taxes of only 14 cents.

TABLE 4.—TOTAL TAXES PER DOLLAR OF NET WORTH IN MANUFACTURING FOR 1978

	Number of firms	Percent	Average asset size (thousands)	Average sales (thousands) [1]	Total taxes per dollar of net worth (cents)	Per dollar of sales (cents)	
						Depreciation	Tax credits
Small business:							
Self employed	5,014	2.3	NA	$961	NA	2.2	0.16
Family size	89,147	42.1	$36.2	112	66.0	2.4	.06
Small	68,475	32.4	242.6	591	23.0	2.2	.11
Medium	41,711	19.7	1,419.5	3,142	21.0	1.9	.11
Large	5,136	2.4	10,096.0	18,115	18.0	2.0	.16
Total small business	209,483	98.9	624.9	1,334	21.0	2.0	.08
Medium business	1,256	.6	48,304.0	73,768	17.0	2.4	.25
Large business	824	.3	42,533.0	1,068,322	14.0	2.7	1.12

[1] Sales are defined to be business receipts.

Source: Internal Revenue Service, Corporate Income Tax Returns, Statistics of Income, 1974.

I would like to refer to another paper from our regional reports (G. S. Lockwood and V. Meyers, "The Effects of Regulations on Innovative Small Business in Region IX"). George Lockwood, one of the authors, is an innovative entrepreneur in the area of aquaculture. This example is significant since here is a chance to significantly increase productivity in our fishing industry. Let me quote a few paragraphs from his paper, "The people in any one agency who must administer its regulations tend to be well meaning, but they are also oblivious of or indifferent to the broad spectrum of regulations that a struggling entrepreneur trying to start a new business must comply with. In case of doubt, they inadvertently err on the safe side to protect whatever they are charged with protecting, no matter what the consequences. They are also completely indifferent with the cost of regulation upon the entity being regulated. The burden they create is oppressive, in fact, it is repressive, and the result is that society is paying an enormous price in terms of the thwarted creativity and initiative of our innovative entrepreneurs."

"It is totally unrealistic to expect an innovator to spend 50 percent to 70 percent of his time on government regaulations. But under current policies that is what the developers of new technologies will be faced with in the future. The only innovators who will succeed in putting science into profitable production will be the few who have the skill and the perserverance to chart and navigate the turbulent regulatory waters. The others, those who know their fields of science and who could cope with normal business problems, but who do not have knowledge, skills, and patience to take on advisory government regulators, will either soon drop out or be too discouraged even to start. The only new industries that will be able to emerge will be those with low regulatory profiles."

"It is unrealistic to expect that large corporations will fill the gap and start exploring new technologies. Large companies wait for individuals to start a new company, pioneer a new technology and establish profitability and then they step in and buy it up. If we are to benefit from the utilization of science, someone must be left free to put science to work. Free entry is basic to economic growth, but the overwhelming involvement of government in the affairs of business is blocking the creative process. That blockage has virtually halted small business innovation in America."

"The evidence is beginning to accumulate that the burden of regulation and paperwork is like a regressive excise tax that hits the smallest firms with effective tax rates many times higher than its larger competitors."

I would like to use a few paragraphs from a recent Chrysler report. Chrysler is obviously not a small business and has had serious management problems, but they are faced with the same problems that small firms face when competing with much larger competitors: "The issue is not whether the most efficient manufacturer will survive in the market; the issue is whether the smaller companies will survive in the market. At present, government regulations give the larger manufacturer a very substantial competitive advantage in the marketplace, not because it is more efficient but simply because it is larger. While it is possible to argue that smaller manufacturers should not receive government advantages compared to larger manufacturers, it seems difficult to adopt a position that justifies government giving the larger manufacturer an economic advantage.* * * Again, the burden of capital expenditures falls most heavily on the smaller companies who must borrow a greater part of their needs and at substantially higher interest rates. Current figures indicate that Chrysler, today, pays an interest cost of approximately $125 per car and General Motors an interest cost of approximately $10 per car.

Again, if these disparities resulted solely from greater economic efficiency and the natural workings of the free market system, Chrysler would have no basis for objecting. But they do not. Disparities that result from government dictated capital spending and borrowing adds to the disproportionate financial burden regulations place on the smaller companies. The question that keeps arising is: should society bear some of the burden either for the cost of meeting its own goals or alternatively, for failing to devise a regulatory system which imposes a more equal tax on all manufacturers? If it is assumed that regulations constitute a tax on a manufacturer and on a purchaser of its products an alternative manner of dealing with the problem might have been to tax each manufacturer a specific amount of say, $200 to $300 a car for each car that it produced. Since each manufacturer would be paying a like tax for each car it produced, there would be no interference with the competitive process and no manufacturer would be placed at a disadvantage because of its size.

As I see it, one basic problem is that the government has unknowingly made it almost impossible for the small firm to compete effectively with large firms. Tax credit and regulatory policies share the responsibility for this along with government procurement policy and the spending on R&D. Instead of helping small business government is creating artificial economies of scale which provide an undue competitive edge to large business. Again, as an example, refer to table 4. Depreciation per dollar of sales for small business is approximately 2.0 cents; for large business it is approximately 2.7 cents. The total of tax credits per dollar of sales for small business is only 0:08 cents while for large business it is 1.12 cents.

Our tax credit package is giving large business 14 times the amount of credit per dollar of sales than it gives small business.

The goal for the Federal Government should, at least, be neutral between firms of varying size that compete against each other in a given industry. Strong arguments can be made that small business provides the employment, sales and productivity growth, the lower prices we desire. It provides the competition which makes our capitalistic system work to everyone's mutual advantage. All of these externalities would suggest, if anything, that the Federal Government should aggressively encourage small business. Instead we find the exact opposite.

In summary, there is a growing body of evidence to suggest that small business, particularly the high-technology, innovative companies, are one of the keys to solving the structural problem facing the United States. Small business provides the price competition which can help reduce the cost-push aspects of our structural inflationary problems. Small business is a primary creator of new jobs and, therefore, can help solve the structural unemployment problems. Small business has more rapid rates of growth in output so can help solve our inadequate growth problems. Small business is important for new innovations, and the competition which small business provides is important for the rapid diffusion of these new innovations throughout a given industry. New innovations and the development of high technology products will be a big factor in solving the deficit in our balance of payments.

It is my feeling that it is time for all levels of government to establish and secure three basic economic rights for all people. First, we should all have the right to live in an economic diverse economy. This means that competition exists in every industry, that you have a broad selection of goods and services produced and distributed by both large and small profit making firms as well as non-profit institutions and government. You have a broad set of employment opportunities working in these diverse economic units. It means we place limits on big business, labor and government. From a policy point of view, the Federal Government should accept the mandate that the share of future increases going to small business be increased by 5 percent in the decade of the 1980's and that this 5 percent increase occur in each industrial categories as defined by the 4 digit or 5 digit SIC Codes. Second, every person should be able to start, own and manage his own business if he so desires. The policy implications here are that the barriers to entry in all industries should be reduced, loan programs should be developed to stress start-up lending to small business. Management assistance programs could provide the new owner and operator the necessary skills to survive. Third, we must insure equality of entrepreneurial opportunity without regard to race, color, creed, sex, age, or national origin. Such a mandate by the Federal Government would insure the healthy growth of the small business sector and this would reduce, automatically the structural problems that we have been facing in the Post War period.

Representative MITCHELL. Thank you very much, Mr. Stewart.

Mr. Birch, I assume you're next. Is that correct?

Mr. BIRCH. Yes, sir. I've submitted a report for the record, and rather than read it, I think I'll just summarize what it says. And I believe that you have copies of it, if that's all right with you.

Representative MITCHELL. Without objection, the report in its entirety will be included in the hearing record.

STATEMENT OF DAVID L. BIRCH, PROGRAM ON NEIGHBORHOOD AND REGIONAL CHANGE, MASSACHUSETTS INSTITUTE OF TECHNOLOGY, CAMBRIDGE, MASS.

Mr. BIRCH. Thank you. For some time now, a group of us at MIT have been very interested in the job creation process. As we dug into it, we put together a file of about 5.6-million business establishments and kept track of each establishment over time.

This sample covers about 80 percent of all private sector employment. And we examined how each business contributed to job growth over the 1969–76 period.

We find that there are great disparities in the rate at which employment grows across the country. The South and West are generating jobs much faster than the Northeast and Midwest. And rural areas are generating them much faster than metropolitan areas now.

Our findings are very consistent with a recent report issued by the Urban Land Institute which shows that nonmetropolitan areas are growing faster than metropolitan ones. The most rapid growth in nonmetropolitan areas is taking place in the most rural counties, and within rural counties, unincorporated, open countrysides are growing faster than nearby towns and cities.

In other words, the more rural you get, the faster your growth at this point.

We find that very few of the differences in employment growth are due to the migration of firms in the sense of hiring moving vans and switching operations running from one place to another. In fact, it's almost a trivial factor. Very little of it is due to differences in the rate at which jobs are lost each year due to the death or contraction of a firm. This rate is a pretty constant 8 percent per year anywhere you go in the United States.

If you can think of jobs in an area like water in a bathtub, which is my favorite analogy, the rate which the water leaks out of the drain is pretty constant everywhere, and it's leaking at a pretty high rate. In other words, each area within the country loses about half of its job base every 5 years. So, the difference between water level in the tubs depends entirely on how fast the faucets filling the tubs are running, and this rate varies a great deal from place to place—the rate at which replacement jobs are created.

So while there is little formal migration in the South or out of the cities, there is a big difference where companies are opening up new facilities or expanding existing ones. This differential investment leads to a substantial migration of capital and causes a significant redistribution of jobs.

From a policy standpoint, I think it's important to understand who is making the decisions to replace lost jobs in new locations and why, which are two of the questions that you have asked me to address.

On whose side, first, from the point of view of these hearings, most importantly, it's smaller companies. About two-thirds of all the net new jobs generated between 1969 and 1976 were generated by firms with 20 or fewer employees.

Establishments generating jobs tend to be young; 80 percent of the replacement jobs were generated by establishments 4 years old or younger. They tend to be volatile, which, to me, is one of the more interesting findings. Volatile firms are much more likely than ever to generate jobs, while stable firms are more likely to die.

Firms that have declined recently but survived are the most likely to grow. And firms that have grown lately are the most likely to decline.

Job-generating firms are more likely to be in the service and trade sectors rather than manufacturing. Between 1969 and 1976, for example, of the 6.7 million jobs generated by firms in our sample, only 105,000 were generated by agriculture; manufacturing actually lost 151,000 jobs in absolute terms. Other industries, including transportation and construction, gained 1.9 million. Trade, including retail and wholesale, gained 2.6 million. And the services gained 2.3 million.

We are obviously no longer centering our growth on a manufacturing base.

Turning to why job-generating firms choose the places they do, we find that cost differences are of increasingly less importance. The most rapid growth areas in the United States tend to have higher than average costs.

And personal considerations of executives seem far more important. These executives speak a great deal about the quality of life, attractive physical environment, schools, and so forth.

In fact, a survey released last January by this committee found that the living conditions were considerably more important than cost considerations in determining where jobs were to be located.

Personal taxes are also very important, including capital gains, as well as income taxes. And I noticed last year Congress took steps to reduce capital gains taxes.

Corporate taxes are relatively unimportant. Virtually everyone who has examined corporate taxes—State and local corporate taxes—have found they make very little difference in location.

Government involvement in regulation is a major deterrent. The more of it, the less likely the replacement will be chosen.

So if you are going to promote in areas of growth by attracting small business to it, you must persuade that area to offer what small business wants; an attractive physical environment and what I would call a proentrepreneur environment.

You've got to keep personal taxes down, particularly capital gains, as well as income, offer less governmental regulation and interference and be sensitive to some of the special needs of small business, like protection against product liability suits and the need for working capital, equal opportunities in Government procurement, and so forth.

I'd like to make one final comment about the effect that the tight money policy might have on all of this.

I am not totally persuaded that history ever repeats itself, but if we look at the 1974–76 period, our preliminary investigation showed that the high cost of unavailable capital during that period had a very negative effect on the independent small businesses.

On the west coast, for example, independent businesses with 50 or fewer employees produced around 235,000 jobs in the 1969–72 period. They produced another almost comparable 174,000 in the 1972–74 period, and that rate dropped to 58,000 in the 1974–76 period to one-third of the level that it had been maintaining before.

The indications that we have so far are that firms in the rest of the country were far worse off than small firms are in California and the West, while the larger, multipart corporations were able to sustain their operations during this period, 1974–76 period.

So, if you are interested in preserving and building upon the job-generating powers of small business, tight money policy is not the way to do it.

Thank you very much.

[The report referred to follows:]

THE JOB GENERATION PROCESS*

(By David L. Birch)

SUMMARY

As our economy becomes more complicated, and as we strive to guide that economy in directions that will make it most productive for those who depend upon it for their livelihood, we must understand its inner workings better. In particular, we must understand how the activities of individual firms combine to create aggregate changes. For it is individual firms, not some abstraction called "the economy," that generate jobs, export products, utilize natural resources, and through their location decisions, determine settlement patterns in this country.

We have known very little about how the parts of the economy fit together to create a whole. Our focus has been either on the whole, and aggregate measures of it (like the GNP and its components), or on the individual firm as the unit of analysis, without reference to how firms combine to create the whole. Input, output analysis is one of the major exceptions to this generalization, striving as it does to relate transactions between businesses to the overall levels of activity in the economy. Welcome as this innovation has been, it suffers (through no fault of its own) from out-of-date data, and it does not trace its anaysis back to the individual firm—only to fairly large aggregations of firms trading with each other as blocs.

Our inability to understand the gap between micro and macro is now seriously hampering our efforts to develop economic policies that will generate jobs for the people and places that need them without causing inflation. We know very little about who generates jobs, where they generate them, who controls those jobs, and who is thus most likely to respond to economic development incentives. In the absence of such knowledge, our approach has usually been to stimulate whole economies with such shotgun-like policies as tax incentives and easy access to money and public works programs. This can be a very expensive and inflationary strategy if, in fact, most of the recipients do not use the incentives to increase employment and/or productivity. What we need, and have lacked, is the ability to target our incentives to those who can make good use of them without wasting taxpayers monies on those who cannot.

The project summarized in this brief paper represents an effort to bridge the gap from micro to macro, and having bridged the gap, to begin to understand the job generation process. We have approached this problem by creating a data file on each of 5.6 million business establishments. Collectively they encompass about 82 percent of all private sector employment. For each establishment, we know, for four different points in time (1969, 1972, 1974 and 1976) the establishment's size, age, 4-digit SIC code, corporate affiliation, location, and sales. By comparing these items over time for the same establishment, we are able to define and measure the processes by which change takes place (new formations, expansions, contractions, dissolutions, and movements) for each establishment. By aggregating establishments in any given place, we can, for the first time, describe in considerable detail how economic change occurs in that place. Thus, in a sense, we have developed an "economic microscope" that permits the policy maker to look beneath the surface, to see what is going on at the "atomic level," and presumably to develop more rifle-like policies that will be in harmony with the observed inner workings.

Our first steps, summarized in this initial report, were aimed simply at understanding the structure of the job generation process. We were interested in answering obvious initial questions. Who generates jobs, and who destroys them? Do the rates of gain and loss vary from place to place or over time? Who controls the process; is it mostly local or does it reach across areas and regions? How do the answers to these questions vary by industry? How can you separate those firms that will create jobs in the future from those who will not based on their past history? These are the questions we began asking, and these are the questions for which intial answers are presented in this report.

We have organized our endeavor into three broad categories: (1) components of change, (2) job generation and (3) interregional control. This brief summary will highlight the major findings and will present summary support for these findings when possible. Detailed analysis and tables are contained in the full report.

* The research forming the basis for this report was conducted pursuant to Grant No. OER608–Z–78–7 from the Economic Development Administration of the U.S. Department of Commerce. The statements and conclusions contained herein are those of the contractor and do not necessarily reflect the views of the U.S. Government in general or the Economic Development Administration in particular.

COMPONENTS OF CHANGE

The first thing we did when we had merged all the establishment records together was simply to examine the relative magnitude of the six basic ways in which employment change can take place:

1. Births
2. Deaths
3. Expansions
4. Contractions
5. In-moves
6. Out-moves

We did this by state and for a set of 315 areas in the United States that are essentially the metropolitan and rural parts of BEA areas. We also did it for several time intervals to see if we could observe any variations caused by the business cycle (see table 1). From these detailed tables we observe:

1. Virtually no firms migrate from one area to another in the sense of hiring a moving van and relocating their operations. The oft-cited move of textiles and shoes from New England to the South represented a rare fluke in the 1950's, not an example of a significant process today.

TABLE 1.—ANNUAL RATE OF EMPLOYMENT CHANGE FOR STATES BY GROWTH RATE[1] OF STATE

State growth rate	Births	Deaths	Expansions	Contractions	In	Out
1969-72:						
Fast	7.5	5.6	6.2	2.7	0.1	0.03
Moderate	6.0	5.2	4.7	2.8	.2	.03
Slow	4.5	4.8	4.0	2.9	.03	.1
Decline	3.9	5.1	3.4	3.2	.2	.1
U.S. average	5.6	5.2	4.7	2.9	.1	.03
1972-74:						
Fast	6.5	4.6	5.8	2.5	.1	.05
Moderate	5.0	4.4	5.0	2.7	.05	.05
Slow	4.3	4.6	4.5	2.9	.2	.1
Decline						
U.S. average	5.5	4.5	5.3	2.6	.1	.05
1974-76:						
Fast	9.5	5.7	5.4	3.1	.2	.05
Moderate	6.9	5.3	4.4	3.3	.1	.1
Slow	6.2	6.1	4.4	3.5	.1	.1
Decline	4.5	5.4	3.6	3.8	.2	.1
U.S. average	6.7	5.7	4.4	3.4	.1	.1

[1] The 4 classes of employment change are: Fast (over 4 percent per year), moderate (2 to 4 percent per year), slow (0 to 2 percent per year) and decline (less than 0 percent per year). On the average, this breakdown divides States into 4 roughly equal groups, although the size of the groups in any particular year is sensitive to the business cycle.

2. The rate of job loss due to the other two processes causing loss (deaths plus contractions) is about the same everywhere and is quite high—8 percent per year. Northern cities are not losing jobs faster than southern ones, nor are cities losing jobs particularly faster than suburbs. It appears to be management skill rather than location that determines job loss. This shows up quite clearly in Table 1, where states are grouped according to their rate of growth. Most of the variation in net change is due to variation in the rate of job generation (births and expansions), not to variation in the rate of loss.

3. The components of change do seem sensitive to the business cycle over time. For most states, births and expansions were fewer and deaths and contractions were more numerous during the economic downturn in the mid-1970's than during the more prosperous period preceding the downturn.

The findings suggest that it makes little sense to attempt to influence firms to move (in the physical sense), nor is there much opportunity, short of influencing the business cycle, to influence the rate at which firms contract or go out of business. Practically all the leverage lies in affecting where new firms locate and where existing firms choose to expand. It thus becomes quite important to know what kinds of firms generate jobs.

JOB GENERATION

We have approached job generation from several different points of view, but the main focus in each instance has been to identify those firms that historically have contributed the most to replacing the 8 percent per year losses caused by death and contraction, so that such firms can be singled out for policy purposes.

Table 2 shows the relative contribution of different types of firms (as defined by their status) to the generation of jobs either by forming new establishments or by expanding.

TABLE 2.—STATUS OF FIRMS VERSUS EMPLOYMENT GAINS BY REGION, 1969–72, 1972–74, 1974–76

Region and time period	Percent employment gains in firms that are— Independent	Headquarters	Subsidiary	Branch/headquarters in State	Branch/headquarters out of State
Births:					
Northeast:					
1969–72	39.0	6.1	5.2	20.3	29.5
1972–74	35.6	4.1	3.9	21.4	34.9
1974–76	23.6	2.0	1.4	31.9	41.1
North central:					
1969–72	39.7	6.3	3.5	16.0	34.5
1972–74	30.3	3.5	2.5	20.4	43.3
1974–76	19.9	1.4	1.1	33.1	44.5
South:					
1969–72	37.1	5.5	4.6	12.8	39.9
1972–74	36.2	3.9	3.0	13.9	43.1
1974–76	25.2	1.6	1.4	21.1	50.6
West:					
1969–72	40.3	5.5	4.1	20.8	29.4
1972–74	44.0	4.0	2.5	21.5	28.0
1974–76	24.0	1.7	1.1	31.6	41.6
Expansions:					
Northeast:					
1969–72	63.1	16.5	4.2	4.4	11.7
1972–74	56.2	20.2	5.8	5.7	12.0
1974–76	58.2	21.1	6.7	4.2	9.8
North Central:					
1969–72	58.3	15.2	3.0	8.1	15.4
1972–74	55.4	20.7	4.6	6.0	13.2
1974–76	54.5	20.9	5.0	6.3	13.3
South:					
1969–72	59.2	13.3	4.8	4.2	18.5
1972–74	56.0	15.9	5.0	3.7	19.3
1974–76	54.2	17.4	5.7	4.6	18.1
West:					
1969–72	60.4	15.6	3.1	7.5	13.0
1972–74	58.2	21.0	3.7	6.0	11.0
1974–76	56.9	22.2	4.6	5.3	11.3

1. Roughly 50 percent of the replacement is due to births and 50 percent is dues to expansions.

2. About 40 percent of the birth-generated jobs and 60 percent of the expansions are produced by independent, free-standing entrepreneurs. In combination, then, about half of the total jobs generated are generated by independents, half by multi-part corporations.

3. Branching is quite important, both in absolute magnitude and in its differential effect on where growth takes place. The south attracts many more branches than the north. Thus it is differential branching, not physical migration, that casuses many of the regional differences in job growth. Also, branching seems to be growing in importance over time.

4. Branching is more important in manufacturing than in other sectors of the economy.

We are still left with the question: What kind of establishments and firms are generating jobs within these broad status categories? Is it large or small firms that are taking up the slack, and in what industries?

Before answering that question, we had to take a complicated and time-consuming step. The data we start with is recorded for each establishment—each separate facility, be it a branch store or plants, a subsidiary, a headquarters or an independent. Yet it is firms, not establishments, that are making job expansion decisions. So, before we can identify the economic scale at which jobs are being generated, we must first bundle all the members of each corporate family into a single entity called the Firm, and then do our analyses for firms.

When we completed the bundling process, we began to ask questions about firm size. We know that the rate of loss is more or less constant for all kinds of firms within places. So we broke out each of the six components of change by size of firm and netted the losses against the gains to see which firms were net job generators. Table 3 presents the results for the United States as a whole. They are rather striking:

TABLE 3.—PERCENTAGE OF TOTAL JOBS [1] GENERATED BY SIZE AND STATUS FOR REGIONS AND THE UNITED STATES BETWEEN 1969 AND 1976

Region: Ownership	0 to 20	21 to 50	51 to 100	101 to 500	500 plus	Total
Northeast:						
Independent	129.1	−11.2	−22.3	−21.1	24.3	98.8
HQ/Br	36.4	10.5	1.3	−6.6	−32.8	8.8
Par/Sub	11.6	7.2	3.6	−5.5	−24.4	−7.6
Total	177.1	6.5	−17.4	−33.3	−32.9	100.0
North Central:						
Independent	52.8	4.5	.3	−2.8	2.9	57.7
HQ/Br	12.4	5.8	3.8	4.9	13.1	39.9
Par/Sub	2.0	1.7	1.2	+1.0	−3.5	2.4
Total	67.2	12.0	5.2	3.1	12.4	100.0
South:						
Independent	42.7	5.7	1.5	0	.4	50.1
HQ/Br	9.3	4.0	2.9	7.4	16.7	40.3
Par/Sub	1.5	1.5	1.1	2.0	3.3	9.6
Total	53.5	11.2	5.5	9.4	20.4	100.0
West:						
Independent	47.8	5.9	2.2	1.9	2.9	60.8
HQ/Br	10.0	4.3	3.0	6.2	8.6	32.0
Par/Sub	1.7	1.4	1.1	1.8	1.8	7.2
Total	59.5	11.6	6.3	9.3	13.3	100.0
United States:						
Independent	51.8	4.4	0	−1.5	3.1	57.8
HQ/Br	11.9	4.9	3.1	5.6	10.6	36.1
Par/Sub	2.3	1.9	1.3	1.1	−.5	6.1
Total	66.0	11.2	4.3	5.2	13.3	100.0

[1] Total jobs generated in each region are: Northeast (410,890), North Central (1,674,282), South (2,873,619), and West (1,800,112).

1. Small firms (those with 20 or fewer employees) generated 66 percent of all new jobs generated in the United States.
2. Small, independent firms generated 52 percent of the total.
3. Middle sized and large firms, on balance, provided relatively few new jobs.
4. There was considerable regional variation in this pattern. Small business generated all net new jobs in the Northeast, an average percentage in the Midwest, and around 54 and 60 percent in the South and West respectively.

It appears that it is the smaller corporations, despite their higher failure rates, that are aggressively seeking out most new opportunities, while the larger ones are primarily redistributing their operations.

This very strong, basic finding raises questions about a life cycle phenomenon. Could it be that most firms start small, that some grow, and that once a corporation has stabilized at some level, it becomes mature and contributes very little to job generation? We began to search for such life cycle phenomena.

A first step was to return to individual establishments and determine which age categories accounted for most of the births and expansions. Table 4 summarizes the results:

1. Young firms play a crucial role, generating about 80 percent of all replacement jobs.
2. This pattern holds across all sectors of the economy and across all regions.

Having discovered that age as well as size made a big difference, we began to analyze along both dimensions separately in most of our work. A first step was to return to the components of change and ask: For those establishments existing in 1969, what had happened to them by 1976, and how did it happen? The results, presented for the United States in table 5, are consistent with our aggregate findings, and add some new dimensions as well.

TABLE 4.—PERCENT DISTRIBUTION OF NEW JOBS CREATED IN EACH REGION BETWEEN 1974 AND 1976 BY AGE OF ESTABLISHMENT

Industry: Region	0 to 4	5 to 8	9 to 12	13 plus	Total
Manufacturing:					
Northeast	67.3	13.9	9.3	9.6	100
North central	75.4	9.9	8.6	6.1	100
South	74.1	15.1	6.2	5.9	100
West	71.0	13.1	8.9	7.0	100
Trade:					
Northeast	78.2	9.4	6.2	6.1	100
North central	81.5	8.5	5.4	4.7	100
South	82.2	8.4	5.1	4.5	100
West	81.8	8.7	5.1	4.6	100
Service:					
Northeast	79.4	8.5	7.4	4.7	100
North central	84.7	7.0	4.6	3.8	100
South	84.8	7.3	4.3	3.6	100
West	87.3	5.9	3.4	3.4	100
Total:					
Northeast	75.5	10.4	7.5	6.6	100
North central	80.8	8.4	6.0	4.8	100
South	80.4	9.9	5.1	4.6	100
West	80.9	8.8	5.5	4.8	100

TABLE 5.—COMPONENTS OF CHANGE BY AGE AND SIZE FOR ESTABLISHMENTS IN THE UNITED STATES, 1969–76

Age	Expand	Contract	Die	Total
Size 0 to 20:				
0 to 4	27.6	7.6	64.8	503,406
5 to 9	32.7	10.4	56.9	372,897
10 plus	33.4	12.5	54.1	882,762
Total	31.6	10.7	57.8	1,759,065
Size 21 to 50:				
0 to 4	25.2	24.4	50.4	20,867
5 to 9	29.9	32.1	38.0	18,950
10 plus	31.3	39.0	29.2	63,415
Total	30.1	34.8	35.1	103,232
Size 51 to 100:				
0 to 4	23.4	29.1	47.4	5,486
5 to 9	26.9	35.1	37.9	5,111
10 plus	28.7	43.6	27.7	20,819
Total	27.5	39.7	32.8	31,416
Size 101 to 500:				
0 to 4	21.7	31.9	46.3	3,369
5 to 9	24.5	37.9	37.6	2,595
10 plus	28.7	45.6	25.7	13,191
Total	26.9	42.2	30.9	19,155
Size 500 plus:				
0 to 4	23.9	39.6	36.6	331
5 to 9	21.0	38.7	40.3	181
10 plus	35.1	46.7	18.2	1,631
Total	32.2	44.9	22.9	2,143
Total:				
0 to 4	27.4	8.6	63.9	533,459
5 to 9	32.4	12.0	55.6	399,734
10 plus	33.1	15.4	51.5	981,818
Total	31.4	12.8	55.8	1,915,011

1. The odds of an establishment dying over this 7-year period are quite high (as we already know from tables 1 and 2 for a shorter interval).

2. The odds of dying vs contracting are quite sensitive to size—with a sharp break around 20 employees. Those establishments below 20 are more likely to die than contract. Those above 20 lay off part of their workforce before going out of business.

3. Of those who survive, small firms are four times more likely to expand than contract, and larger firms are 50 percent more likely to shrink than to grow.

The odds of an establishment dying, growing, or declining give little feeling for the magnitude of the resulting employment changes. Table 6 gives us a feeling for the distribution of employment generation by age and size. Now we can see the relative magnitude of the changes as well as their direction. As can be seen:

1. The corporate population is quite volatile. Conditional on surviving, establishments are almost as likely to experience big changes as small ones—particularly small establishments. While there is some clustering around the mean, it is not nearly so great as we had anticipated.

TABLE 6.—PERCENTAGE CHANGE FOR ESTABLISHMENTS BY AGE AND SIZE FOR THE UNITED STATES, 1969-76

Size	Death	Percent employment change						
		−50 to −99	−25 to −49	−1 to −24	0 to 24	25 to 49	50 to 99	100 plus
Age 0 to 4:								
0 to 20	62.7	2.8	2.9	1.6	10.1	2.9	4.4	12.5
21 to 50	46.4	8.9	6.3	7.3	14.7	5.2	5.1	6.2
51 to 100	44.3	10.7	7.2	9.3	13.8	6.0	4.1	4.6
101 to 500	43.6	10.6	9.2	10.2	13.5	5.0	4.7	3.2
501 plus	33.3	11.8	12.4	11.8	18.5	6.1	4.4	1.7
Total	61.7	3.2	3.1	2.0	10.4	3.0	4.4	12.1
Age 5 to 9:								
0 to 20	53.7	3.8	3.8	2.3	13.8	3.8	5.5	13.4
21 to 50	34.4	11.1	8.2	9.6	18.3	6.0	6.1	6.2
51 to 100	34.7	12.5	9.4	10.3	16.6	6.1	5.5	4.9
101 to 500	34.8	13.0	9.3	12.8	16.2	6.0	4.6	3.4
501 plus	37.2	14.3	10.7	10.7	14.8	8.2	1.0	3.1
Total	52.4	4.3	4.1	2.8	14.1	3.9	5.5	12.9
Age 10 plus:								
0 to 20	50.2	4.2	4.4	3.0	16.2	4.3	5.7	12.0
21 to 50	25.5	11.1	10.2	12.7	23.1	6.9	5.7	4.7
51 to 100	24.7	13.2	11.5	14.1	21.0	6.4	5.2	3.8
101 to 500	23.1	13.9	11.9	15.2	21.5	6.3	5.0	3.1
501 plus	15.9	13.3	10.8	16.6	27.2	7.1	5.7	3.5
Total	47.5	5.1	5.1	4.1	16.8	4.5	5.7	11.2
Total:								
0 to 20	54.4	3.8	3.8	2.4	14.0	3.8	5.3	12.5
21 to 50	31.2	10.7	9.0	11.1	20.6	6.4	5.6	5.3
51 to 100	29.6	12.7	10.5	12.7	19.1	6.3.	5.1	4.1
101 to 500	28.1	13.2	11.1	14.0	19.4	6.1	4.9	3.2
501 plus	20.2	13.1	11.1	15.4	24.9	7.0	5.1	3.2
Total	52.4	4.4	4.3	3.2	14.5	4.0	5.3	11.8

2. This phenomenon is not very sensitive to age. Maturity does not guarantee stability in the harsh corporate world. Each year is a new year, and the fact that an establishment has survived for 10 years seems to have little effect on what will happen to it in the 11th year other than increasing its odds of being there.

The fact that age has little effect on next year's expectations does not mean that the recent experience of the establishment should have no effect. If we wish to identify firms that promise to generate jobs in the future, one potentially interesting clue is likely to be the experience of the firm's establishments in the recent past. With three different time intervals in the files, it is possible to trace the history of each individual establishment. The first two intervals (1969–72 and 1972–74) were treated as history, and we assessed what effect this five-year history had on the ability of the establishment to survive and/or thrive in the rather difficult period 1974–76. In particular, we defined seven possible historical trajectories through 1974:

	Types and number of changes	Magnitude of change 1969–74
Trajectory:		
1	2 expansions	Big increase.
2	do	Small increase.
3	1 expansion/1 contraction	Big increase.
4	do	Small change.
5	do	Big decrease.
6	2 contractions	Small decrease.
7	do	Big decrease.

where a big change is greater than 50 percent and a small change is less than 50 percent over this 5-year interval. Table 7 reveals the behavior of each establishment that survived the 1969–74 period during 1974–76. Some of the results are what we expected, some are very surprising (but consistent):

1. Two periods of expansion substantially lower the odds of death in the third period, and tend to raise the odds of a substantial gain in the third period.
2. On the other hand, a big gain in the past tends also to lead to a higher than average expectation of a big loss. Volatility cuts both ways; what has gone up has a higher than average tendency to go down in the next period.
3. The biggest gainers of all, curiously but very consistently, are establishments that declined the most during the recent past, but survived. These establishments have a higher than average expectation of dying, but, if they make it, they are the ones most likely to generate a large number of new jobs in the future. On balance, they are in fact two or three times more likely to be large job generators.
4. Firms that didn't do much of anything in the past (one up, one down, not much change)—the so-called stable firms—are among the most likely to die and the least likely to expand. There is not much to be said for stability.
5. There is little variation in these tendencies across regions and industries.

A pattern begins to emerge in all of this. The job generating firm tends to be small. It tends to be dynamic (or unstable, depending on your viewpoint)—the kind of firm that banks feel very uncomfortable about. It tends to be young. In short, the firms that can and do generate the most jobs are the ones that are the most difficult to reach through conventional policy initiatives.

TABLE 7.—INFLUENCE OF PREVIOUS HISTORY ON IMMEDIATE FUTURE OF ESTABLISHMENTS IN THE UNITED STATES, 1969–76

Size: Number and type of changes, 1969–74	Mag. of change, 1969–74	Change: 1974–76				
		Big+	Neutral	Big−	Death	Total
Size 0 to 20:						
2 expansions	Big increase	11.2	68.1	16.4	4.3	82,396
Do	Small increase	10.2	77.7	9.3	2.8	6,902
1 expansion/1 contraction	Big increase	9.4	63.8	10.5	16.3	321,777
Do	Small change	9.6	56.9	6.8	26.7	731,939
Do	Big increase	17.8	55.8	3.3	23.1	38,349
2 contractions	Small decrease	13.5	68.3	10.3	7.9	9,820
Do	Big decrease	23.1	58.8	5.9	12.2	8,355
Total		10.0	59.7	8.4	21.8	1,199,538
Size 21 to 50:						
2 expansions	Big increase	10.6	68.6	16.7	4.1	5,722
Do	Small increase	7.6	80.1	9.5	2.8	3,073
1 expansion/1 contraction	Big increase	9.3	64.6	18.8	7.3	8,664
Do	Small change	8.4	68.3	11.7	11.7	72,515
Do	Big decrease	18.3	56.2	8.7	16.8	8,350
2 contractions	Small decrease	8.6	70.6	13.4	7.4	3,187
Do	Big decrease	20.0	57.2	9.8	13.0	2,933
Total		9.7	67.1	12.2	11.0	104,444
Size 51 to 100:						
2 expansions	Big increase	9.3	68.6	18.0	4.0	1,691
Do	Small increase	7.3	81.4	9.2	2.1	1,186
1 expansion/1 contraction	Big increase	8.1	63.5	20.0	8.5	2,376
Do	Small change	7.9	67.8	12.7	11.5	23,651
Do	Big decrease	18.1	56.4	10.0	15.5	3,095
2 contractions	Small decrease	7.8	72.0	13.0	7.2	1,407
Do	Big decrease	19.1	54.3	12.1	14.5	1,123
Total		9.2	66.7	13.1	10.0	34,529

TABLE 7.—INFLUENCE OF PREVIOUS HISTORY ON IMMEDIATE FUTURE OF ESTABLISHMENTS IN THE UNITED STATES, 1969-76—Continued

Size: Number and type of changes, 1969-74	Mag. of change, 1969-74	Change: 1974-76				
		Big+	Neutral	Big—	Death	Tota
Size 101 to 500:						
2 expansions	Big increase	8.6	70.4	16.9	4.1	1,029
Do	Small increase	6.0	79.1	11.4	3.4	1,059
1 expansion/1 contraction	Big increase	6.6	68.6	17.1	7.6	1,491
Do	Small change	6.9	68.3	12.2	12.6	19,046
Do	Big decrease	16.4	58.6	9.8	15.2	2,097
2 contractions	Small decrease	6.9	72.0	15.3	5.9	1,173
Do	Big decrease	21.1	51.8	14.5	12.6	902
Total		8.2	67.7	12.6	11.6	26,797
Size 501 plus:						
2 expansions	Big increase	5.7	74.5	18.9	0.9	106
Do	Small increase	6.0	79.1	10.9	4.0	201
1 expansion/1 contraction	Big increase	6.5	74.0	14.0	5.5	200
Do	Small change	6.1	72.5	11.0	10.4	3,708
Do	Big decrease	12.8	65.6	12.4	9.2	282
2 contractions	Small decrease	3.7	74.4	15.3	6.6	242
Do	Big decrease	14.4	60.6	14.4	10.6	160
Total		6.6	72.2	11.7	9.5	4,899
Total:						
2 expansions	Big increase	11.1	68.1	16.5	4.3	90,944
Do	Small increase	8.9	78.8	9.5	2.8	12,421
1 expansion/1 contraction	Big increase	9.4	63.8	10.8	16.0	334,508
Do	Small change	9.4	58.5	7.6	24.6	850,859
Do	Big decrease	17.8	56.1	4.9	21.2	52,173
2 contractions	Small decrease	11.4	69.4	11.6	7.6	15,829
Do	Big decrease	21.9	57.6	8.0	12.6	13,473
Total		9.9	60.6	8.9	20.5	1,370,207

INTERREGIONAL CONTROL

There is a nagging question that persists throughout the debate over growth in different parts of the country: To what extent is apparent growth in one part of the country (like the South) really being controlled by firms headquarters elsewhere (like in the North)? As corporate families were bundled together, we were careful to keep track of the location of the parent or headquarters of each branch or subsidiary. We are thus now able to address this question. As we observed earlier, branching is the main form of corporate expansion. Table 8 shows the extent of the interregional control of branches. As can be seen:

1. There is a great deal of interregional control. While the majority of jobs generated in branches and subsidiaries in a region tend to be under the control of headquarters and parents in the same region, this is not always the case, and in many instances, the majority is a bare majority.
2. In manufacturing, the great majority of jobs generated in the South are controlled in the Northeast and North Central parts of the country.
3. Relatively few corporations anywhere are opening or expanding facilities in the Northeast. The North Central section is slightly better off.
4. Even in the trade sector, almost two thirds of the Southern growth is controlled by northern corporations.
5. Only in the service industries does each region tend to dominate its own territory, with the interesting anomaly that, in this newest and most rapidly expanding sector of the economy, southern corporations are dominating northern and western establishments. In branches, for example, southern headquarters generated almost as many service jobs in the Northeast as northern firms did, substantially more jobs in the midwest than midwesterners did, and substantially more jobs in the West than westerners did.

We thus see a strange mix of old and the new. While northerners continue to dominate the declining manufacturing sector as it relocates (through differential investment) in the south, entrepreneurial southerners are latching on to the growing service sector and are aggressively dominating the generation of jobs in this sector throughout the country. In the process, they are effectively precluding entry by northerners in the South by dominating the growing southern market.

TABLE 8.—PERCENT DISTRIBUTION OF NET EMPLOYMENT CHANGE DUE TO DIFFERENTIAL TREATMENT OF BRANCHES BY HEADQUARTERS

Industry: Location of headquarters	Controlling branches in— Northeast	North central	South	West
Manufacturing:				
Northeast	53	30	31	29
North central	34	59	41	39
South	7	4	16	12
West	6	7	13	21
Total	100	100	100	100
Other:				
Northeast	65	23	23	19
North central	21	57	18	23
South	7	11	43	4
West	7	9	16	53
Total	100	100	100	100
Trade:				
Northeast	65	18	21	16
North central	25	68	35	32
South	5	8	37	7
West	5	6	7	45
Total	100	100	100	100
Service:				
Northeast	48	14	13	14
North central	8	33	7	7
South	40	50	75	47
West	4	3	5	32
Total	100	100	100	100

On a more general level, there is a tremendous amount of interregional influence and control. Corporations do not hesitate at all to open and expand operations elsewhere in the country as it suits their needs. We cannot at all assume that each region holds its destiny in its own hands. In fact, a much safer assumption is that half (or more) of the jobs generated by multi-establishment corporations in a region are controlled outside of that region.

CONCLUSION

It is no wonder that efforts to stem the tide of job decline have been so frustrating—and largely unsuccessful. The firms that such efforts must reach are the most difficult to identify and the most difficult to work with. They are small. They tend to be independent. They are volatile. The very spirit that gives them their vitality and job generating powers is the same spirit that makes them unpromising partners for the development administrator.

The easier strategy of working with larger, "known" corporations whose behavior is better understood will not be, and has not been, very productive. Few of the net new jobs generated in our economy are generated by this group. Furthermore, the larger corporations, using their financial strength, are the first to redistribute their operations out of declining areas into growing ones. They do not hesitate to locate branches in greener pastures, placing an even greater burden on the smaller firms in struggling areas like the Northeast.

There is no clear way out of this quandary—there are only general guidelines—and most of them are of a negative, "do not" nature. Do not, for example, expend resources attempting to stem physical migration—in the textile industry sense—because it is relatively insignificant and counterbalancing. Do not count on, or address major resources toward, larger corporations, whose powers of net generation are small and whose tendencies to shift location quickly are well demonstrated. Do not try to influence the rate of job loss, since it is practically the same in all states, and worry instead about how to encourage job replacement.

Advice on how to encourage job replacement is more difficult to give. We know that smaller, volatile firms are the major replacers of lost jobs, but we have no experience in identifying and assisting them in large numbers. Because they are small, we must reach many of them to have a measurable effect. Because they are volatile, we must monitor each individual firm's performance carefully if we are to gain maximum benefit from our invested dollars (on the high side) and avoid scandal (on the low side).

From this research's viewpoint it seems like a very difficult problem to solve administratively. A massive bureaucracy would be required to monitor individual small businesses on the scale required to change the direction of an area's economy. New England alone houses about 193,000 businesses with 20 or fewer employees, not to mention those in the 20 to 500 range (another 27,000). And New England represents a relatively small percent of the national total. It seems almost certain that our approach must be indirect, not direct, relying on existing networks of institutions rather than building large new ones.

It is not clear what to offer job-replacing firms. Some have argued persuasively that small businesses need, use well, and cannot easily get, capital. Beyond that, however, the answers are less clear. Most studies of location find that local corporate tax differences are a relatively unimportant reason for choosing a location. Our own work on factor costs [1] suggests that, in many important instances, factor costs differences are small and/or are disappearing and that, even when they are large, they do not have a dominant effect. The most rapidly growing places in the United States in the 1970's tend to have higher than average factor costs.

Our own survey work, and that of others,[2] suggests that, for many businesses, the quality of life experienced by the managers of companies is very important. They want to avoid personal (as distinct from corporate) income taxes, crime, congestion, and the hassle of government regulation and want to find places which they find physically attractive with good schools and housing and recreational activities. We plan to delve much more deeply into this phenomenon in the months ahead. Suffice it to say here that strategies of economic development may have to address the quality of the physical environment of a place and the attitudes of its local government at least as much as the immediate economic problems and needs of its corporate inhabitants if they are to be successful.

The puzzle is a complicated one. We cannot afford to spend large sums on incentives that generate a relatively small number of jobs. But nor can we afford to ignore the effect that corporate decisions are having on millions of individuals and households. We must learn to shoot with a rifle rather than a shotgun if we are to be effective and noninflationary. Rifle-shooting requires a kind of knowledge that we simply have not had, and must obtain if we are going to do it at all well.

Representative MITCHELL. Thank you, Mr. Birch.

Mr. Rennie, before you proceed, I'd like to indicate that we intend to share the entire transcript of this hearing with all of the members of the Senate and House Small Business Committees.

This is very vital information that you are providing us, and I think the members will benefit singularly from exposure thereto.

Please proceed.

STATEMENT OF JOHN C. RENNIE, CHAIRMAN, INTERNATIONAL TRADE COMMITTEE, SMALLER BUSINESS ASSOCIATION OF NEW ENGLAND, BOSTON, MASS., AND PRESIDENT, PACER SYSTEMS, INC., BURLINGTON, MASS.

Mr. RENNIE. Thank you, Congressman. I appreciate the opportunity to appear before this committee to express my thoughts on the essential role of small businesses in strengthening the balance of trade in the United States.

I am testifying with two hats today, first, as the chairman of the International Trade Committee of the Smaller Business Association of New England, and also as the president of a smaller company that is exporting.

[1] See Birch, "Regional Differences in Factor Costs: Labor, Land, Capital and Transportation." MIT Program on Neighborhood and Regional Change, 1978.

[2] See a recent analysis of 3,000 central city businesses by Matz entitled Central City Businesses—Plans and Problems" (Joint Economic Committee, 1979).

I felt it might be helpful to the committee if I began by telling you something about my own company—Pacer Systems—a smaller business located in Burlington, Mass. We manufacture aviation flight simulators and low-range airspeed systems, and have a total of 125 employees.

Two years ago, out of about $3 million in annual revenue, our export sales were $20,000. This year, our revenues have reached $5 million, and our export sales represent over a half million dollars of this total, or 10 percent. There is no question but that our company's success abroad has helped us to grow and to create jobs here.

I might add that our introduction to the export market in 1977, was a result of my participation in the small business export program which is administered by the Massachusetts Port Authority in conjunction with the Smaller Business Association of New England.

In 1978, the U.S. trade figures showed a deficit of nearly $28.5 billion. Although the factors explaining this deficit have been well documented, the negative impact of this deficit is no less disturbing. The weakening value of our dollar, the intensified inflationary pressures of our own economy, and the increasing instability in the world economy are all tied into our continuing trade imbalance.

With 317,000 individual manufacturing firms employing nearly 20 million people and producing the world's broadest range of high quality, innovative products, the essential resource required for us in the United States to compete effectively in the world markets is solidly in place. Something less than 10 percent of the U.S. manufacturers actively export their products. And 85 percent of our total exports of manufactured goods can be attributed to 250 of the largest companies in the United States. Manufacturers with less than 250 employees represent 9 percent of our manufacturing base and make only a very small contribution to the overall U.S. exports.

This low participation by small business is a concern for two reasons:

First, with 300,000 small manufacturing businesses in the United States, their potential for impact on the U.S. trade picture is significant. If we could get just 10 percent more of these firms, or about 30,000 companies, to begin exporting so that over the next 5 years they reach a level of $1 million in export sales each, the result would be an additional $30 billion of manufacturing exports.

According to Department of Commerce multipliers, an additional $30 billion of exports would result in a total GNP increase of $60 billion. One can make different assumptions and use different mathematics, but regardless of the way one estimates, there is no question that an increased number of small businesses breaking into the export markets would have a substantial impact on our world trade position.

Second, in a time when we are worried about capital availability, small business failures and job creation, small businesses can increase their own profit potential and ability to grow by increasing their marketplaces to include foreign countries.

The typical small business usually manufactures a limited line of products which they are naturally dependent upon. This makes them more subject to economic swings in the marketplace. They basically have three choices in maintaining their market shares: They can continue to improve upon their existing products, something that is usually mandatory for continued profits; they can diversify so that they are not solely dependent on the success of a single product; or they can increase the size of their marketplace.

By increasing their market size through export, they become less subject to the cyclical impact of localized economic downswings. They can smooth our traditional seasonal curves, making both the supply and reserve demand more consistent. In short, they have spread their risks and increased their profit potential by not being dependent on one marketplace.

While there are many advantages for the small business who exports, there are also distinct disadvantages for the manufacturer who does not export.

If an American manufacturer of a unique or marketable product leaves a void in the world market, that void will often be quickly filled by a foreign company who is not intimidated by international selling, as is his American counterpart. Not only are we facing foreign competition in oversea markets, but we are increasingly facing it here in our domestic markets.

The 1970's have given birth to a new wave of international marketers and entrepreneurs who are penetrating markets domestically that were once considered safe from outside competition.

I might add that many features of the new Multilateral Trade Agreement enhance their chance of success. American small businesses must expand their entrepreneurial horizons to include foreign markets if they are to continue to hold their own as the backbone of the American manufacturing industry.

The benefits which accrue when small businesses begin exporting are significant and can lead to an obvious question: Can U.S. small business take advantage of the opportunities of overseas?

The answer, in our opinion, is a definitive yes. Because of its size, a small business enterprise has specific advantages which often give it the edge over larger companies in export markets. While they cannot match the sales organizations or research staffs of the multinational, they are in a better position to take a rifleshot approach and concentrate on a particular market in a more direct manner.

For example, small businesses are able to offer their foreign buyer the following advantages:

First, flexibility in pricing. In the absence of worldwide pricing agreements and established pricing patterns and policies, the smaller company can raise or lower their prices to meet individual market conditions either on an ongoing or introductory basis.

They can negotiate such matters as quantity, service, and transportation, all of which affect the price more easily and more quickly than their larger corporate competitor. And, in many cases, can offer a lower price and still maintain their profit because of their lower overhead costs.

Second, personalized service. Every buyer, whether it be an individual or corporate purchasing agent, prefers to deal with the top person. The small business person can offer the kind of service whereby the customer needs to talk to only one person about all their questions or complaints, rather than be bounced from one corporate department to another.

In addition, the small business person can usually respond more quickly whether it be on pricing or servicing. This can be extremely important in establishing a new market overseas, since the foreign buyer is seeking to develop a high degree of confidence in their new trading partner.

Third, the smaller company's willingness to modify. The smaller company, again, has the edge here on the larger manufacturer in that they are in a better position, while still maintaining the profitability that they desire, to adapt their product to the particular needs and specifications of the new marketplace—customizing their product to fit the industrial application or to accommodate the buying pattern and customs that prevail in the foreign marketplace.

Finally, economics of scale. In many situations the smaller company can successfully go after a particular market, or segment of a market, where their larger counterpart would find the cost of retooling or the size of the marketplace itself of such nature that it would not absorb their overhead cost and make it profitably viable.

So, in summary, one can simply state that the flexibility inherent in a smaller company allows it to move more quickly, be more decisive, and more responsive than its larger corporate counterpart.

Not all small businesses have exportable products, but a great majority of them do and are ready to take the first steps toward entering export markets. Their entrepreneurial efforts, assisted by programs such as we have going at SBANE and the MassPort program, in combination with new initiatives on the part of the U.S. Government to offer them assistance, can lead to a successful expansion of their marketplace. This offers potential significant economic benefits to small business and to our overall economy.

Thank you, Congressman Mitchell.

Representative MITCHELL. Thank you, Mr. Rennie. I thank all three of you gentlemen.

I have to state that we have lots of hearings in the Congress and very often the hearings do not prove to be beneficial.

I think this was just excellent testimony that all three of you submitted this morning, and it certainly will give me, as a member of the Small Business Committee and a member of the Joint Economic Committee, some guidance as to legislation that I will be thinking about or looking at some suggestions for some administrative changes in the agencies.

As chairman of the Subcommittee on Domestic Monetary Policy, next month we will have Chairman Volcker here to testify on these unusually dramatic changes that he's instituted at the Federal Reserve Board.

I put this question to all of you. In a recent hearing before the Senate Small Business Committee, Prof. William Dunkelberg of Purdue University reviewed the effect of the current economic situation on small business. He arrived at a very interesting conclusion: That is, that although the tightening of monetary policy would cause a short-run dislocation for small businesses, the reduction of the inflation through these policies would be, and I'm quoting him now, "worth the short-term trauma."

The small businesses are less able to cope with inflation than large businesses.

I would like for all three of you gentlemen to comment on Professor Dunkelberg's very interesting conclusion.

Mr. BIRCH. Well, I'm not sure exactly what he would base such a conclusion on. The evidence that we have suggests that in a period, particularly of tight money and recession, there are two different phenomena. And in 1974–76, both were going on at once.

We're not exactly sure what is going to be going on in the 1979–81 period.

Certainly, from the little evidence that we have, tight money—and it's been historically well known that tight money has a very strong effect on the mortgage market, on the small businesses.

Furthermore, the larger business differentially is much less effective because it has retained earnings. It has depreciation, it has all sorts of internal sources of capital to work with; whereas, the small business, if you jerk it to a 90-day credit for a month, it's very close to the edge.

It's hard for me to imagine how that's sort of soul-building or good for the moral fortitude of the small business, particularly if it goes bankrupt and isn't around.

If you say it's good to shake out the bottom of the small business market, I don't see that as any inherent advantage that I can see, particularly given that that's the major source of job creation in the country.

In other words, you're taking away the people who are creating more than half of all the jobs, and as Milt Stewart points out, perhaps employing, or more likely to employ, that part of the labor force that we feel would be most affected by a recession on the poorer end rather than the wealthier end of the labor market.

So I find it, in the absence of evidence that I could see that he would present, that he says this is a good thing. I find it a little difficult to agree with him.

Mr. Stewart, can you see any benefit in eliminating a large number of small businesses?

Representative MITCHELL. Well, that's not quite the way Professor Dunkelberg put it.

Mr. BIRCH. That's the spirit in which—certainly, the effect of that, we know from empirical evidence, is to eliminate a very large number of small businesses.

Mr. STEWART. Let me try to get at my response this way, Congressman Mitchell.

I think I understand what Professor Dunkelberg is saying. As a matter of observable fact, he's talking about the whole small business sector, and the damage that inflation does to it.

Even if he is correct in his conclusion, I'm not sure that he's addressing the most important problem, which to me is the differential impact of inflation on large and small business.

It is this difference in impact on the two that concerns me. I don't believe that small business has the market power to create inflation. Individual businesses are in the most competitive sector of the economy; their prices are kept down by competition. They have to be alert entrepreneurs; they have to be responsive to the market, and they can't passthrough increases in cost as easily as large firms.

So that it seems to me that we keep talking about inflation fighting techniques and procedures as if we have one money maket when, in point of fact, we have two. That's the central problem that I hope we will be discussing with Mr. Volcker and his colleagues in the months and years ahead.

The question is whether we cannot fine tune monetary policy a little better so that, when we raise interest rates or raise reserve requirements, we can relate them a little better to the people who are to bear the burden.

I think we can.

Representative MITCHELL. Mr. Rennie.

Mr. RENNIE. Yes, I think that you could possibly say that the business of running a small business is to overcome short-run dislocations in the hope of gaining some long-term benefits.

I think, unfortunately, that small companies would never survive the short-run dislocation. The underlying feeling generally in the small business community is, as Mr. Stewart has just said, simply that we bear a disproportionate amount of burden of the tight money policies.

I think I would just go to one point, and that is that over the last 10 years or so, there has been a really critical lack of available long-term captial for small businesses, and especially small businesses like my own, that's growth-oriented, that segment of small business that generates the jobs and so forth.

The larger you grow, the more investment you have to make and the greater your cash flow is, and so the need for money is greater.

With the lack of long-term capital, more and more of the small companies have been relying on the only source that they know, which is the short-term market. And, as Mr. Birch said many are relying on the 90-day notes or are operating on secured revolving lines of credit.

Even now, a fairly substantial company that is, say, operating on a secured revolving line of credit, would normally be paying 3 points over prime, could easily be paying 6 percent over prime.

So now you have a considerable number—and these aren't really fly-by-night companies that I'm talking about. You have smaller companies paying 20 percent or thereabouts, maybe more now, with the latest rise, 20 percent for short-term money.

So, as Mr. Birch said, we don't have the availability to the long-term capital markets and we have two choices: We either have to stop growing, which can be fatal in itself, but at a minimum, you just stop in job creation and the rest of it, or we do the best we can on the short-term money, or we sell to a larger company and become absorbed and relieve ourselves of that burden.

So I think definitely we are hurt much more and we need some kind of a special treatment for small businesses when such things as reserve requirements are raised.

If I'm going after the same dollar as Raytheon, I know who is going to get it.

Representative MITCHELL. Thank you very much.

Actually, the problem is really there are two aspects, as I see it, with the Federal Reserve.

As you gentlemen well know, a few short years ago the Congress, in cooperation with the Federal Reserve, instituted a policy where the Chairman would come before the Congress—the Chairman of the Federal Reserve—and establish a floor and a ceiling for monetary growth.

I think this year it was something like 4½ floor and 6½ percent ceiling.

To the extent and degree that the Fed is now moving from its monetary policy, which was averaging 11 percent per year back within those ranges, I don't think that will hurt small business.

On the other hand, I think the actions taken by the Fed raising the discount rate at the window, upping reserve requirements, I think these will have an enormous impact on credit, which will probably be more devastating to small business than would be the changes in the monetary policy.

Would you generally agree that perhaps the more hurtful aspect of this is on the other side, with reference to credit?

Mr. STEWART. Yes, indeed. I'd like to say two nice things about the Chairman of the Fed, because I have to say so many not nice things from time to time.

Mr. Volcker wrote all of the banks of the United States just yesterday, asking them to make a special point of continuing to make loans to small business. He has tried to say to them that he hopes the cutback they make will be in the financing of speculation in the commodities markets, and so forth.

Second, this time, at last, the Fed has begun to control the problem of the $600 billion Eurodollar float, and which is an essential part of big business' ability to resist tight money policies.

Representative MITCHELL. It's very nice Chairman Volcker did that. Unfortunately, it has been my experience that increasingly, banks are loathe to lend to small businesses and to lend at a 20-percent rate is just as invidious as not lending at all.

I'm glad Mr. Volcker sent his letter. I'm not at all sure it will have a salutary impact.

Mr. Rennie, let me put another question specifically to you, although the other gentleman may want to respond.

What, if any, help has your company gotten from such instrumentalities of government as the Eximbank, the Overseas Private Investment Corporation, or the Department of Commerce itself, in terms of facilitating the entry or the growth of small businesses in international trade?

Mr. RENNIE. In my particular case, we have not used the Eximbank. The Overseas Private Investment Corporation, although I am familiar with it, we're not—we haven't matured to the point where we get into the types of programs, I think, OPIC normally focuses on, such as investing, say, in a plant in a lesser developed country.

We look at those programs as potential for us as we mature a little more. We haven't done much there.

In terms of the Department of Commerce, the principal role that they have played so far has been in the supplying of information, you know, just general background and so forth.

Although we are familiar with several of the programs, many of them we find to be somewhat cumbersome or they're just not necessary for our kind of things. So we use the Department of Commerce as a source of background information and kind of a way to stay out of trouble, or just find out about what types of activities are around.

I should mention, Congressman, that we in various capacities, including my involvement in the international trade part of this White House conference, the small business conference coming up in January, are pushing very hard for the Commerce Department to take a more active role.

I mean, there's an awful lot of people there who have done a lot of work.

You can see that when they bring in this stack of information, brochures and all different kinds of orientation material.

But the record, the real results of all this, if we look at the real small business participation in trade, is not there. And one of the reasons we feel is because the Commerce Department has had something of a passive role. And I'll point out an example.

One of the key things that American companies are going to have to know in order to really move ahead in trade—and this is especially true with smaller companies—is what I would call the marketing information, the requirements in foreign markets.

Now, the Commerce Department has, of course, sections of most embassies and consulates around the world, commercial sections, and these people get this information.

Again, sometimes it may be somewhat passive, but, nevertheless, there is a great deal of information which filters into this group.

Now, one of the first changes we are highly recommending—and this is a point which most of us did not realize—that when a Department of Commerce employee is posted to an embassy or a consulate, he is changed in his line of command and actually works for the State Department while he's on that assignment.

We feel this changes his orientation; and we would really like to see him remain as a Commerce Department employee and stay oriented in the Commerce Department line.

Second, we would like to see the Commerce Department take a much more active role pushing information back to the United States, some of which is done now, but rather than leaving it in the depository in Washington here and sort of saying, "We have all this information, so come and get it if you want it," to push this information out into the regions at a minimum.

And we have suggested as a very effective method, we think even beyond that would be to formulate a foreign commerce business daily, in effect, the Commerce Department on a subscription basis, you know, more or less self-sustaining, putting out all these foreign leads that they get across the world.

And with this new trade agreement that has been opened, it's much easier for a West German company to find out what the U.S. Government is procuring than it is for me to find out what West Germany is procuring.

So, I mean, that's a typical idea. We would like to see them become more active with the idea that it's good for the country to boost exports.

Let's try and promote that in a much more active way.

So up until now, to answer your question, I have not used it other than as background. But I feel the potential is there to be greatly helpful.

Representative MITCHELL. You made some excellent recommendations. I have been very critical of both Eximbank and the Overseas Private Investment Corporation. When they come before various committees, I have just openly criticized them for not showing a greater interest in the involvement of the small businesses in trade.

Mr. Stewart, do you have any comments before I go on to the next question?

Mr. STEWART. I think not; I have to be an expert on so many things, I try to leave foreign trade to my friends.

Mr. RENNIE. Congressman Mitchell, I would like to say in the last year, OPIC has started a much more active program of a kind of outreaching to small businesses around the country. And I know that they have already had one meeting up in our region and have had several around the country.

They are having a second seminar of sorts there later—I think it's in November, in Springfield, Mass. And so they have mounted increased effort—your inputs apparently had some effect because they have made an attempt now and are making an attempt to try and become at least familiar with the small business input and try and find some common ground.

Representative MITCHELL. Mr. Stewart, as you know, I work very closely with small businesses and small and disadvantaged businesses, and I always press a theme that you refer to—the necessity for some kind of diversification, to break away from the single product line.

Do you have any idea as to what percentage of small businesses in the country continue to operate on just a single product line?

Mr. STEWART. I really don't. Perhaps Mr. Birch could help us. I would guess, in the manufacturing field, no more than, and Mr. Rennie may know, no more than 10 percent of the small manufacturing in this country I think make more than one thing.

That's a wild-hared guess. In retailing and service, it's a little better. But the small business people in these fields do try to diversify their markets and try to find different kinds of people to sell to and, of course, you will find sharp small business people who make ski equipment going into the tennis business to lick seasonal trends, that kind of thing.

But, on balance, one of the advantages big companies have is diversification, as you suggest.

Mr. BIRCH. In terms of lines of business, which is a slightly more general concept than a particular product, which might be classified, therefore, by the Labor Department and so forth, very few business establishments have more than one line of business that they are engaged in.

In other words, they tend to be highly focused with—I think your wild-hared guess was a very accurate one—it's around 10 or 11 percent that would have more than one line and no more than 1 or 2 percent would have more than two lines.

So, most establishments tend to be very narrow in their products range.

Mr. STEWART. One more point, Congressman. This is why disproportionate, burdensome taxes and regulations are so serious. When an entrepreneur has a choice of whether to go on doing what he is doing and to try to sell more of what he makes, or to develop a new product or process, he's got a critical investment decision to make.

How much risk does he take with how many dollars each way?

The blunt fact is, his cash flow, when he's through meeting regulations and paying taxes, sharply limits his ability to undertake innovative activity.

That's one of our principal concerns.

Representative MITCHELL. Apart from the matter of regulations, and I won't ask any of you gentlemen to respond to this immediately, but I would like to hear from you later on. What specific recommendations would you make toward helping to increase the percentage of small businesses that you would diversify?

What can the Government do?

And I certainly would not ask you to respond to that now, but I think it's an area which we need to probe.

Obviously, in the next question I will be very calm and dispassionate and not emotional. This is not in response to the enormous, almost criminal profits that I think the large oil companies are making. So I will remain objective and dispassionate and not emotional.

But would you comment on the feasibility and perhaps efficiency of divesting the oil companies of some of their interests, breaking up horizontal and vertical integration?

Mr. RENNIE. I'll defer to Mr. Stewart.

Representative MITCHELL. Doing that, breaking up the horizontal and vertical integration, hopefully, to increase the efficiency of the small businesses.

Which of the stalwarts will comment on that?

Mr. STEWART. Several weeks ago, Congressman, I finally had to make up my mind on one part of the question you're asking.

One of the things I think I get paid to do is to hold down government regulation and limit the impact of government on the entrepreneurial environment.

But your colleague, Chairman Bedell, of the Small Business Antitrust Subcommittee, held a hearing on the problems of small gasoline stations as one of a series that he held all over the country. We held some hearings on this in Advocacy in California and elsewhere, and I went home and I really thought about the numbers. In 4 years, 50,000 gas stations in this country have gone out of business, leaving 150,000. I asked myself the question: What is going to change that? The market share of oil company owned-and-operated stations has gone up sharply, and I asked. "What's going to change that?"

I couldn't find a good answer to either question. So I think we're going to be confronted directly with the question, whom do we want to operate gas stations? Neighbors running neighborhood facilities, or the oil companies running them?

I don't have any doubt about what's better for this country.

I have made it plain that I am talking for myself, and neither for the SBA nor the administration. But, as far as I'm concerned, I am in favor of divesting oil companies from retail distribution right now. Second, I am in favor of decontrol once we have done that, but not until we have done it.

Once we have done it, we can rely on competition at the retail level.

Representative MITCHELL. I'm almost constrained to utter a fervent amen to at least a portion of your statement.

Oh, by the way, for the recorder, please be sure to indicate that I said, "almost criminal behavior" in the profits of the giant oil corporations.

Along the same line, the Federal Government, it seems to me, has the responsibility here also. Far too often in the Department of Defense contracts and other contracts, the size of the contract is just so enormous that it precludes the effective participation of small business.

That's my opinion.

Do you have any comments at all about breaking up the size of Government contracts to facilitate the well-being of small businesses, Mr. Rennie?

Mr. RENNIE. Yes, sir. I have some firsthand experience with this myself.

A part of my company provides services to many Department of Defense agencies or large contractors. The trend, as a matter of fact, has been in the opposite direction from what we would like to see in recent years, here in Washington, especially.

What has happened is that, of course, a number of reductions in force or whatever the contracting arms of these establishments, so that if they were behind before, they were getting just impossibly behind in contracting compared to what was needed to be done. And more and more people were—either programs were being slowed up, or the jobs.

What happened is the contractor would have to work precontractually quite a lot of the time. And I have had to do that myself in the sense they say if you want the work, you have to start next Tuesday.

And I know as soon as I accept that, that I won't get a contract for maybe 3 months. So here I am paying my people each week with 15 percent money and, of course, the ceiling on the fee of the contract is 9 percent, or, depending on the form of the contract.

So the solution to this has been to combine contracts so that instead of having a large number of smaller contracts, let's say two-, three-, or seven-man-level job, they would combine it into one.

That way it makes the contracting thing more simple and, you know, just kind of reduces the workload.

However, the net effect is exactly what you said: That it's prejudicial to the smaller company and makes it very difficult for a startup for a very small service company or even a manufacturer.

But I am thinking particularly of service jobs to break in. We used to pick up contracts of say $50,000, $100,000 level; more and more now, these are for $700,000, $800,000, more than $1 million.

And not only that, but the requests for proposals say that you have to put in your proposal, the résumés with the names of, say, 20, 30, 50, or 80 people that are going to work on this job.

Well, there's just no way. We don't have 20 or 30 people waiting around to see if we win this competition.

So, as a result, you just end up not bidding it and so the competition narrows down to the larger companies that can do that. And this is a very common practice and we have been fortunate in the sense that we happen to be large enough that we can occasionally take on these jobs, you know, if they're not huge 80-man jobs.

But if it's a 10- or a 15-man job, we usually have the credibility to bid it.

But 10 years ago, or even 7 or 8 years ago, when I was considerably smaller, there was just no way I could bid those jobs.

So you're exactly right in this area. I think something has to be done about it because you're going to wind up not being able to break into this at all, and in many cases the many small service companies have great economies. They have very specialized knowledge that just doesn't exist in the established industry.

Representative MITCHELL. Thank you.

Mr. Birch, could I direct a couple of questions to you? Let me do it in my own meandering way, if I may.

One of the great pleasures of life for me some years ago was to wake up at 11:30 at night, feel some hunger pangs, slip on a sweater and a pair of trousers and go get a nice corn beef sandwich at 11, 1, or 2.

I can't do that anymore. The delicatessens are gone from the central portion of the city. More specifically, my question is: Have you looked at the movement of small business from center city to the periphery of the city, or even to the counties?

Is there any discernible trend that you are aware of?

Mr. BIRCH. Yes. We are right now in the process of figuring out which neighborhood that each business in each of 10 metropolitan areas is located, looking at it neighborhood by neighborhood, as distinct, say, from central city versus suburb, in very refined detail.

We have also been able to identify 20,000 minority-owned businesses so we can examine the experience of minority-owned businesses as distinct from other kinds of businesses, to see if they are having more or fewer problems.

Our initial analysis has been central city versus suburb. We have looked at that. Again, the rate at which businesses are losing jobs is not substantially greater in the city than in the suburb. The rate at which they are starting up is very dramatically different.

In other words, the small businesses that fail each year—the 80 percent per year that I was mentioning—they tend to keep failing at about that rate, but there are no replacements. So there's no one to fill their shoes; whereas, there are a lot of shoe fillers in the suburban areas and, as I said earlier, the rural areas as well.

So you have the bathtub leaking about the same as it always leaked, but there are no faucets. There's nothing filling the tub. So the effect that you're seeing is really a lack of replacement of any kind because no one has decided to start up a small business in many of those inner-city neighborhoods, for many of the reasons thay tour committee found in the survey which you conducted last January.

So that is, I think, the problem you're examining—a lack of replacement.

Representative MITCHELL. My second question: Here in this committee we have been looking at employment in the 1980's—what are the prospects?

The witnesses that we have heard support your testimony and the testimony of the other two gentlemen that there will be a growth in retail service trade industries.

If these predictions are correct, I'd like to get your thoughts about what the prototype for employment in the 1980's is? What kind of people are we looking for? Are we looking at a higher-skill level or lower-skill level?

Do you have any thoughts on that at all?

Mr. BIRCH. Yes; we have looked at it carefully. I think one of the first difficulties people have in thinking about this is they think of the service sector as just taking in each other's wash, and I once heard it described by a leading official in the State from which I come, considered as parasites.

I think the first thing that we have to do is dispel the notion that people in the service sector are parasites. In fact, they perform real services which are exported either regionally, nationally, or internationally, and create real jobs, just the way manufacturers do.

And I explained to him that perhaps manufacturers were the real parasites of the people who do mining in this country and the people who grow the food today, which, of course, is also true.

And at that point, the discussion sort of trailed off.

The simple fact is, if you look at a place like the city of New Haven, many, if not most, of its larger employers are in the service sector. They include Yale University; they include the Knights of Columbus, which is, I believe, the largest private insurance corporation in the world; they include the Yale medical facility, which is a very large employer, and those facilities have been growing and creating job opportunities in the city of New Haven, while the manufacturers—the Olin's and the Winchester's—have been deteriorating and leaving the city in the lurch.

On top of that, the banking community, the insurance community in a city like Boston, our universities, our hospital complex, that's where the employment growth is. That prototype is a relatively well-educated, rather than less well-educated work force.

Below, it creates a lot of opportunities at the low end of the spectrum as well—clerical opportunities in fairly large numbers, so that it's really a knowledge-based industry that we're speaking about and a skill-based industry which, in turn, creates a number of secondary jobs.

And those are exported all over the world.

The Port of Rotterdam is right now being rebuilt by a Houston developer. Development services is one of the major things we offer. This is not just momma and poppa grocery stores, dry cleaning stores, TV repair shops; it's a much more global kind of activity, very large, and they seem to be quite good at it. And I think that's one of the major bases on which we are expanding our job picture right now.

Representative MITCHELL. Very interesting. I agree with you.

It flies in the face of some testimony we heard in the employment hearings that, obviously, the job opportunities would be much greater for blacks, Hispanics, and other minorities if we see an unprecedented growth in the retail trade and that kind of thing because it would require relatively little skill and training.

But I disagree with the witness who made those statements and I certainly think that you're on the right track. Service businesses are no longer simply sweat businesses. They do require skills and training.

Mr. BIRCH. Very much so. One of my favorite examples is this little town up in—New Hampshire recently has been something like the second fastest growing State east of the Mississippi. It's second only to Florida. And if you look at New Hampshire's growth and where the growth is coming there in these little towns scattered around New Hampshire, you find it's in the mail-order business, which is a form of retailing; you find it's in publishing—they produce Yankee magazine and all sorts of magazines and all forms of wholesaling, retailing, that kind of thing, and almost none of it is in manufacturing.

And people have got to start generalizing their concept of what service is. It's almost a poor term. It's an unfortunate term because it tends to mean, as you say, sweat jobs, parasites—those are all very bad words and not really very descriptive of all of what these folks are doing.

Representative MITCHELL. Any other comments? I thought you had a comment, Mr. Rennie.

Mr. RENNIE. Yes. I think I'm taking a somewhat different tack, looking at it from the manufacturing side.

Currently, I think there is absolutely a chronic lack or chronic shortage of highly skilled and semiskilled people. It's amazing to me that up near us we have the three largest companies in the country that have developed these computer-assisted drafting machines and so forth, each one of which is supposed to be able to do the work of 12 draftsmen.

Yet, there are no free-floating draftsmen around, despite the fact that one of these companies went from $15 to $25 million a year in sales in 1 year and dropped in market share because the whole business was growing so rapidly.

What I see from the manufacturing viewpoint is that as we look forward to, say, the 1980's and early 1990's, we see an absolute drop-off in the number of younger people coming into the labor force, just due to the reduction in births and so forth.

So by the late 1980's and early 1990's, there really will be fewer people in this 18-to-25-year age group and, as such, the only way that the manufacturers can really plan in the long-term basis, that I can see, to keep their productivity reasonable and improving and keep their output increasing—I mean domestically, at least—is to increase their capital expenditures on more and better machinery, and so forth to reduce dependency on skilled labor. I think you will see a reduction, or let me say an emphasis on processes that would tend to reduce labor, rather than increase it because they see a shortage coming up.

So I see little relief for the unskilled. And in that area, I think there will be a tendency to be able to make do with machines with the skilled and semiskilled people.

That would be the way they will tend to drive the thing. And where they need unskilled people, probably, they will take advantage of some foreign sources of very low-level people, rather than domestically.

It seems to me that's the drift.

Representative MITCHELL. Why would they take advantage of that?

Mr. RENNIE. Well, more often than not they can get various incentives or tax breaks of one type or another, or they can have things like, you know, tax holidays and so forth for foreign investment. So, in other words, they could build a plant in less developed countries, or they could go to Singapore or something, and know, Malaysia, and set up a plant over there for far less money and probably have a much lower cost of labor than they do here.

So I think, short of any real parallel incentive in this country to employ these kinds of folks, I just don't see it happening. I think more often than not, they would go overseas for it.

These things can change, of course, as the standard of living increases in the foreign countries, too.

Representative MITCHELL. I understand exactly what you're saying. You have made it very clear. But I think that it's terribly tragic.

Mr. RENNIE. I agree.

Representative MITCHELL. You've got blacks and Hispanics with structural unemployment that has persisted for decades and now, instead somehow, the Federal Government in tandem with the private sector is addressing the problem of the structurally unemployed, they're going to abandon that approach altogether and move toward machines and investments abroad.

I think that's kind of a sad commentary on this Nation's willingness to deal with the very crippling and chronic problems of structural unemployment.

Mr. STEWART. I think there are two things that perhaps ought to concern this committee, my own office, and everybody concerned with the kinds of problems we have talked about.

One is the significance of the coming miniaturization and reduced cost of a whole range of electronic devices. These are going to have a tremendous impact on retailing, wholesaling, and the service trades—microprocessors and minicomputers, for example—things that in the recent past have cost many hundreds of thousands of dollars to buy will now be available to small businesses.

I'm not sure myself what the impact of this is going to be. Will small business, as historically the most labor-intensive part of the economy, go automated and begin, at least short term, creating unemployment instead of adding the jobs as it has always done?

I think not.

I think really what is going to happen is that we are much more likely to see small business become more competitive than it has been before. But the problem I think is there, and I think we ought to be addressing it.

Second, I don't believe that there is any way out of the problems of our domestic "third world." It has two parts. First, our unprivileged, left-behind population; blacks, Hispanics, and the rest of the minorities; older people; and first-job people. Second, is the small business sector. Those are our homegrown third world.

I think that, over the long term, our solution there is going to have to be a kind of multiskilled society, where people can change jobs more easily. We are going to have to find ways where, as the economy and the technology change, people can change occupations.

We are going to have to, again, put a premium on the multicareer lifeline rather than the single-career life. I think that our society is going to get that demanding and that complex in terms of skills.

I haven't thought this through, but I think it's something that we're all going to have to consider.

Representative MITCHELL. Permit me just one last question. You have been here a long time and, fortunately, I have been able to stay with you and not be summoned to the Capitol so far this morning.

Just one last question for all three of you gentlemen. It's really two questions. The first one I'll ask you to respond to in writing, and that's some recommendation in terms of changes in tax policies.

We refer to this recommendation that would be beneficial for small businesses. Each of you gentlemen, I think, has referred to the unfairness, the lack of equity in the present tax structure insofar as small business is concerned.

So if you will drop me a note on that with your recommendations, I would appreciate it.

The question I would like for you to respond to this morning is: Of the array of Federal efforts presently directed toward assisting small business and of the array of government efforts in general in the business world, what can this Congress do in terms of targeting more effectively to benefit small businesses?

We have mentioned one or two—breaking up the large contracts, possibly some breaking up of enormous corporate structures which reap enormous, unnecessary profits.

But above and beyond those two, what other specific recommendations can you give me this morning?

Mr. STEWART. Congressman Mitchell, I'm a little loaded for this. I had a taskforce of 20 presidents of small science-based companies—entrepreneurs who were the heads of innovator kinds of businesses that create jobs faster than any other kind. They came up with a series of recommendations to improve the entrepreneurial climate for such people, to encourage them to start new business.

That's the gut problem, as Mr. Birch has suggested, and Mr. Rennie, too. Their recommendations are part of a domestic policy review. The President is going to be sending recommendations up next week.

But the general thrust of legislation on innovation, which has just been introduced by Representative Neal Smith in the House and by Senator Gaylord Nelson in the Senate, and 20 Members, I think, subsumes my priorities.

That, I think, is the highest priority facing this Congress for small business.

Thank you.

Representative MITCHELL. Mr. Rennie.

Mr. RENNIE. That's a broad question. I have been trying to think, coming up with all the different areas. I think certainly to increase the attractiveness for the startup or the entrepreneurial company, which really to me says that you have to try to create the correct climate.

I think there's sometimes too much emphasis on what can the Government give me, or some kind of handout or guaranteed loan and so forth.

In many cases, small businessmen don't really need that, or they don't particularly want to use it. They just want to have the right climate, which means they can start—then he can start up his business and get needed capital without getting too caught up in having his private house and the rest of his assets tied up in it. Then if he makes some money, he can take the benefit of it either to increase his company or take it out of the company.

I think, in a very general sense for small business representation in the area of trade, for example, we have recommended that there be a real small business representative on the President's Council, for example, so that when various trade issues come up and the Administration is considering them, at least there would be some voice.

I guess the ideal thing from our viewpoint would be to have a small business trade council so that specific problems regarding small business trade could be attacked and not mixed up with all the, you know, opinions and heavy weight that the larger company representatives would have.

Maybe Mr. Birch can throw a couple in. I might think of some more. I just kind of had a whole rambling group of them.

Representative MITCHELL. Excuse me just 1 minute, Mr. Birch. I just wanted to make a comment on what Mr. Rennie said.

Perhaps, in general, you are correct about the need of the small businessmen vis-a-vis the Government. Perhaps, generally, they want a client and not necessarily Government help. But perhaps generally that's correct.

However, in terms of minority businesses, I think that the minority businesses, because we are so late coming into the picture, cannot possibly survive nor grow unless there is strong, persistent governmental help made available to them.

Hopefully, the day will come when we will have established a more viable minority entrepreneurial class and we won't need that.

But certainly now, and for the foreseeable future, minority dependence on government assistance is absolutely vital.

Mr. BIRCH. On that topic, we were at a hearing in Denver recently and it's clear that in Government procurement, that small business is at a substantial disadvantage. And that's something that I think, which is very programmatic, can be emphasized as affecting minority small business as well as small business.

We heard a marvelous—it wasn't marvelous—it was depressing, but very well stated argument by a woman who runs a tire dealership in Los Angeles, telling about the frustration that she has had in trying to compete for procurement, offering a better price and not being able to get anywhere because specifications are written in very osbcure ways.

I think, looking at Government procurement and really working at that is something that is very direct and can have a very positive effect.

I was going to say also that the staggering thing that comes out of my numbers and my looking at them is the extent to which small business has succeeded and generated two-thirds of the jobs despite all of the adversity we speak of. And when we tend to look at where they get their money from, which is a major issue they face and which has been made several times today, it seems to come as much from private sources as it does from instituations, banks, or Government programs.

I have been talking with my Canadian friends somewhat and one of the things you might consider—and I'll try and make some notes on this for you—is the incentives to individuals to be able to make investments in small corporations rather than Government programs, to try to go the other way, because, in fact, that's where most of the funds come from in the first place.

So that you might well want to consider how the individual tax structure, the individual creation and use of wealth, might be utilized more effectively, as well as the incentive to the entrepreneur himself or herself as regards the tax structure.

The Canadians are thinking very strongly now about changing the personal tax structure from the corporate tax structure to give more incentive to the individual, both investor and entrepreneur.

Mr. STEWART. Just a footnote there Congressman Mitchell. That's an idea that has been under discussion and sort of floated around that I have tried to sharpen recently in talking to delegates to the forthcoming White House conference. I think it deserves some attention from someone like you.

Frankly, that is the whole idea: When you cut the capital gains tax for everybody, that's a good thing for private investment, obviously, but it doesn't help small business as much as it helps big business because there's no differential in it.

And what I have been playing around with is this kind of idea—and I'm not sure that in our present inflationary times the Treasury would have anything to do with it. But, at some point, it seems to me that it might be very timely.

Let's assume that our present capital gains rate is about 26 or 28 percent.

It bothers me that, if I'm handling somebody else's money, or my own, if I buy a share of stock in a major company and I hold it a year and a day, I'm going to take a gain or a loss.

If I go into a small business or a minority business and I hack my guts out for 25 years and I give jobs to people and I sell my interest in that business, the Government is going to tax me on the same basis exactly.

And I say that's the Government telling me don't invest in small and minority business.

So we ought to have a capital gains differential rate. And I think it might work something like this. If you put your own money in a small business and you keep it in for at least 5 years, you're taking a lot more risk than if you buy a share of stock and sell it.

You will be taxed at 50 percent of normal capital gains rate. And if you put your money in a business which is of national interest significance like a business that conserves energy or a business that creates a new product for export—and a list of such businesses could be maintained by the SBA Administrator and he could issue certificates—I don't like bureaucracy, except for good purposes like this, or if you put your money in a minority business or a business owned by women and you left it in there for 5 years and you made money, you'd be taxed at a still more preferential rate, maybe only 25 percent of the normal capital gains rate.

It's only when we can make these admittedly unattractive areas of private investment differentially more attractive by things the Government does to private investors that we're really going to get someplace, in my own opinion, and we can unleash, really, the tremendous resources in the private sector.

That's the kind of thing I think we maybe ought to be thinking about most.

Representative MITCHELL. That's fascinating, and you and I need to get together.

Mr. BIRCH. That's precisely what the Canadians are talking about. The Canadian Federation of Independent Business is strongly advocating this to the Canadian Parliament right now—differential treatment for taxation of investments made by individuals and small business and/or other kinds of business.

Mr. RENNIE. Congressman, I believe there is a bill that's currently under consideration and it probably would be unreasonable to expect it to pass this year. But I have read the bill—I'm sorry, I don't recall it—but the subject of it is the establishment of a new type of essentially small business investment medium, which is referred to as the small business participating debenture.

And this has many of the same features that Mr. Stewart just mentioned.

Essentially, it would be a subordinate kind of debt, and the person who was to invest in this case gets various and sundry incentives to do so, both when he invests—he gets an investment tax credit of some sort, I believe, and also, in case the debt becomes nonviable, then he gets considerable advantage on maybe like an ordinary loss, and so forth.

There's a whole series of things to make these really quite effective. And the bill struck us, and I believe that probably Mr. Shattuck or someone from the Small Business Association of New England has testified in favor of this type thing.

There may be a few technicalities that would have to be worked out, but generally, it would be an excellent instrument. It would provide a better medium for really enhancing the attractiveness of making small business investments.

And this is very much like the—that's what reminded me of this, when Mr. Stewart mentioned it just now.

I think that, just to add one footnote here, although it's generally basic, I think the thing that we really would like to see is a sensitivity to small business through two ways: First, a real and meaningful consideration of the small business impact when legislation goes through or is coming through the committees; and second, to really seriously consider threshold or exemptions in various regulations so that below certain levels, whether it's assets or however the criteria are defined—and they might not necessarily be the same for each piece of legislation or each regulation—that businesses below a certain threshold would be exempted from a lot of the regulatory things that come all the time.

I think those two things in general, if we could get a real sensitivity in these areas and then some small business representation on such things as the President's export council, I think we would begin to sort of from inside out have a terrific change in the impact of small businesses in this country.

Representative MITCHELL. Thank you, gentlemen. I have sat where you are presently sitting on many occasions before I came to Congress. I used to come out to testify frequently. I often wondered, what are they going to do? Is it really worthwhile my coming over here?

I want to assure you that this has been a very, very meaningful session for me and there will be a followthrough.

Having served on the Banking, Finance and Urban Affairs Committee, the Small Business Committee, and the Joint Economic Committee, some of the ideas that you have suggested this morning I hope to effectuate through those other two committees.

Thank you very much for being here. It was very stimulating and most provocative.

This committee stands adjourned.

[Whereupon, at 11:25 a.m., the committee adjourned, subject to the call of the Chair.]

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