

WEST MICHIGAN VIEWPOINT

Importance of Small Businesses: It Matters How You Measure It

It has become common knowledge that small businesses create almost all new jobs. Indeed, a recently released study by the U.S. Department of Labor shows that from 1993 to 2003, tiny firms—those employing from one to four workers—accounted for 127 percent of all net employment growth. Tiny firms were able to create more jobs than the nation as a whole because larger firms lost jobs during the same period. Such a finding, of course, has important policy implications, as it suggests that small business development should be a top priority.

Unfortunately, common knowledge is often off the mark, and the job-creation prowess of small businesses may be overrated. In the same study, the authors use an alternative methodology called “dynamic sizing,” which leads them to conclude that tiny firms accounted for only 10 percent of all net employment growth during the quarter, not 127 percent.

Turns out it all depends on how the job growth is tabulated. Below, I hope to convince you that the traditional methodology is flawed and that the new approach, dynamic sizing, provides a better assessment of the limited job creation ability of small firms.

To illustrate the difference between the two approaches, I offer a theoretical example using five firms, labeled A through E. Firm A is the classic gazelle: it starts with only two employees and expands to 25 by the end of the fifth quarterly period. The other tiny firm, Firm B, starts small and stays small. The next two firms, C and D, grow, and the fifth firm, Firm E, a larger firm, declines. On net, 33 new jobs were created among the five firms, a 30 percent increase.

The traditional approach allocates this job growth by grouping firms by size in Period 1 and then tracking the resulting employment change. Not surprisingly, because of the outstanding employment growth in Firm A, the sample’s tiny firms (A and B) accounted for 73 percent of all net job gains. Small businesses create almost all new jobs.

Not so fast. The alternative approach reaches a different result. The dynamic-sizing approach regroups firms each quarter according to their previous quarter’s performance and records the job changes that occurred in each size category. To show how it works, let’s look at the gazelle, Firm A. In the second period, it doubles in size but remains in the 1-to-4 size category. In the third period, its employment climbs to 15 and it skips past the 5-to-9 size group and lands in the 10-to-19 category. The dynamic-sizing methodology records its job gains as zero for the 1-to-4 group, five jobs in the 5-to-9 group and six jobs in the 10-to-19 group. In the fourth period, it adds five more jobs; four in the 10-to-19 group and one in the 20-to-49 group. The firm adds yet another five jobs in the fifth period, all recorded in the 20-to-49 group. Clearly, the resulting tally for Firm A using the two methodologies is dramatically different. All of the firm’s growth is recorded for the tiny 1-to-4 group in the traditional approach, while when the alternative method is used, job gains are reported in the size groups that the growing firm passes through during its growth spurt.

Looking at the 50-or-more size category, the results are different as well. In the traditional approach, the top category loses 10 jobs during the period because of the decline in Firm E. In the dynamic-sizing approach, employment in the category grows because all of Firm E’s job losses are recorded in the smaller 20-to-49 group, while some of Firm D’s gains are captured in the 50-or-more category. A greater share of the resulting job gains are allocated to the largest category, 50-or-more, than to the smallest category.

The Department of Labor has decided to use the dynamic-sizing method in calculating the “official” quarterly employment change. I think the economists there are right. This measuring approach confirms the importance of a balanced approach by economic developers of nurturing the business environment for all of a region’s strong, growing firms, not just its smallest.

Comparison of Measuring Methodologies							
Firms	Period 1	Period 2	Period 3	Period 4	Period 5	New jobs	Percent
A	2	4	15	20	25	23	1150.0
B	3	6	6	3	4	1	33.3
C	9	12	20	15	17	8	88.9
D	45	45	52	53	56	11	24.4
E	50	48	47	45	40	-10	-20.0
Total	109	115	140	136	142	33	30.3
Traditional method							
Employment by size	Change from previous period				New jobs	Percent	
	1 to 2	2 to 3	3 to 4	4 to 5			
1 to 4	2 (A) + 3 (B)		5 (A) - 3 (B)	5(A) + 1 (B)	24	72.7	
5 to 9	3 (C)	8 (C)	-5 (C)	2 (C)	8	24.2	
10 to 19						0.0	
20 to 49	0 (D)	7 (D)	1 (D)	3 (D)	11	33.3	
50 or more	-2 (E)	-1 (E)	-2 (E)	-5 (E)	-10	-30.3	
Total	6	25	-4	6	33	100.0	
Dynamic-sizing method							
Employment by size	Change from previous period				New jobs	Percent	
	1 to 2	2 to 3	3 to 4	4 to 5			
1 to 4	2 (A) + 1 (B)	0	-1(B)	1 (B)	3	9.1	
5 to 9	2 (B)	5 (A) + 0 (B)	-2 (B)	0	5	15.2	
10 to 19	3 (C)	6 (A)+ 7 (C)	4 (A) - 4 (C)	2 (C)	18	54.5	
20 to 49	-2 (E)	1 (A) + 5 (D) - 1 (E)	1 (A) - 1 (C) - 2 (E)	5 (A) - 5 (E)	1	3.0	
50 or more	0	2 (D)	1 (D)	3 (D)	6	18.2	
Total	6	25	-4	6	33	100.0	