

SMALL BUSINESS, ECONOMIC GROWTH,
AND THE HUFFMAN CONJECTURE

by
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This Essay examines the role of small business in the process of economic growth and the effects of increasing regulation and civil liability. First, the Essay explores the basic mechanisms of economic growth in society and explains how small business, as opposed to large business, contributes to economic growth. Next, the Essay analyzes to what extent increased regulation and civil liability disproportionately impacts small business operations and the effectiveness of various Congressional benefits and preferences toward small business in relieving these perceived burdens. Finally, Priest applies this analysis to various issues attending the role of small business in economic growth. The Essay concludes that satisfying more particularized consumer demands enhances consumer welfare, that small businesses are likely to be more effective in achieving this end, and that forms of regulation or civil liability that differentially affect small businesses reduce societal welfare.

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I. INTRODUCTION

This Essay addresses various issues relating to the role of small business in the process of economic growth and the effects of increasing regulation and civil liability on that small business role. In the United States, largely for political and, perhaps, historical reasons, small business¹ has attained a status of veneration as constituting the most basic foundation of growth in the economy. As one of a multitude of examples, *The State of Small Business: A Report of the President 1997* states:

Small businesses represent the individual economic efforts of our Nation's citizens. They are the foundation of the Nation's economic growth: virtually all of the new jobs, 53 percent of employment, 51 percent of private sector output, and a disproportionate share of innovations come from small firms. Small businesses are avenues of opportunity for women and minorities, first employers and trainers of the young, important employers of elderly workers, and those formerly on public assistance. The freedom of America's small businesses to experiment, create, and expand makes them powerhouses in our economic system.²

Though the specific numbers change from year to year, these various claims are a fixture of the Presidents' State of Small Business annual reports.³ Passages of this nature reflect, in essence, three claims about the contributions of small business to the society. First, there is a claim that small business contributes significantly to the economic growth of the nation—"virtually all" of the new jobs; a "disproportionate" share of innovation. Second, there is a claim that small businesses are differentially successful in providing economic opportunities—not only generally, but in particular to marginal workers such as women, minorities, the elderly and the young; opportunities that are, presumably, not available or less available in employment in firms of larger industrial size. Third, there is a claim that working in small businesses engenders personal values that are related to economic activity, but which possess a substantial non-economic normative character as well: values such as independence and self-reliance.

These claims regarding the contributions of small business provide the justification for the many ways in which Congress promotes or provides economic advantages to small business. Congress has enacted special programs involving small business finance, simplified securities registration, special forms of tax treatment, and debt relief, among many others.⁴ Moreover, in specific appropriation bills, Congress often enacts set-asides or other

¹ The definition of what qualifies as a "small" business is equally the subject of political forces. The definitional question is addressed *infra* notes 17-23.

² THE STATE OF SMALL BUSINESS: A REPORT OF THE PRESIDENT 1997, at 3 (1998) [hereinafter STATE OF SMALL BUSINESS 1997].

³ THE STATE OF SMALL BUSINESS: A REPORT OF THE PRESIDENT 1999-2000 is the latest available on the web, available at http://www.sba.gov/advo/stats/stateofsb99_00.pdf (2001).

⁴ For a review of many of these programs, see Joshua E. Husbands, Comment, *The Elusive Meaning of "Small Business"*, 2 J. SMALL & EMERGING BUS. L. 355, 364-70 (1998).

differential premiums that direct government procurement toward firms that meet the relevant (and often changing) qualifications as “small business.”⁵ All of these various programs are justified on the grounds of the importance of small business to America’s individualistic values and in stimulating economic growth.⁶

Despite these various programs, however, there remain continual concerns about the health of small business in our modern economy. Various commentators have addressed the seeming relative disadvantage of small business to large in responding to and complying with increasing levels of local, state, and federal regulation in our society. The most thorough of these modern treatments is an article written by Dean James L. Huffman.⁷ In this Article, Dean Huffman puts forth the conjecture that compliance with the various forms of health and safety, employment, environmental, and economic regulation in the U.S. over the past decades has differentially burdened small in comparison to large business.⁸ According to what I will call the Huffman Conjecture, this differential burden derives from the imposition through regulation of a form of both fixed and variable costs on enterprises that have substantially more debilitating effects on the contributions to the economy of small business in comparison to large.⁹ The conjecture is highly plausible. In addition, although the point has not been fully elaborated, the expansion of enterprise liability in tort law since the 1970s could be argued to equally impose differentially burdensome costs on small business.

Congress has not ignored these concerns but, surely, has not addressed them completely. In 1980, Congress enacted four separate statutes dealing with small business problems.¹⁰ More recently, in 1996, Congress enacted the Small Business Regulatory Enforcement Fairness Act,¹¹ compelling federal regulatory agencies to consider the effects of their policies on small business.¹² The effectiveness of these legislative enactments has never been determined. On their face, of course, they extend only to federal but not state and local regulation, and they do not address in any way the impact of increased civil litigation.

⁵ See, e.g., National Defense Authorization Act for Fiscal Year 1987, Pub. L. No. 99-661, 100 Stat. 3816 (1986) whose effects will be discussed *infra* note 45 and accompanying text.

⁶ See Husbands, *supra* note 4, at 358-59.

⁷ James L. Huffman, *The Impact of Regulation on Small and Emerging Businesses*, 4 J. SMALL & EMERGING BUS. L. 307 (2000). For another treatment of this question, see WILLIAM A. BROCK & DAVID S. EVANS, *THE ECONOMICS OF SMALL BUSINESSES* (1986) and sources cited therein.

⁸ Huffman, *supra* note 7, at 308.

⁹ *Id.* at 313-14.

¹⁰ This legislation is discussed *infra* note 37-41.

¹¹ Pub. L. No. 104-121, 110 Stat. 847 (codified as amended in scattered sections of 5 U.S.C., 15 U.S.C., and 28 U.S.C.).

¹² See generally, Thomas O. Sargentich, *The Small Business Regulatory Enforcement Act*, 49 ADMIN. L. REV. 123 (1997).

I do not contest the importance of individualism or self-reliance as values central to the country nor the importance of small business in promoting them. There is a question, however, as to exactly how small business, as opposed to large contributes to economic growth? Secondly, to what extent can we observe the conjectured deleterious effects of increased regulation and civil liability on small business operations? Finally, what has been the impact of the various Congressional benefits and preferences toward small business?

This paper will attempt to analyze these questions from an economic perspective. Part I addresses very simply the basic mechanisms of economic growth in any society. Part II examines the role of small business in an economy. As we shall see, small business, as opposed to large, is likely to be of increasing significance in the particular context of discrete markets where economies of scale are technologically unavailable. Part II will also address these small business questions using the economic theory of determinants of firm size, developed most prominently by Ronald Coase and George Stigler. Part III addresses the effects on small business of increased regulation and civil liability—reviewing the Huffman Conjecture—and the, presumably, converse effects of the various incentives and benefits created for small business by Congress. Part IV attempts an empirical test of the proposition that small business has been differentially affected by the modern increase in regulation and civil litigation. It presents some preliminary empirical evidence (preliminary because of the difficulty of deriving useful data from the multitude of statistics published by the Small Business Administration) supportive of the Huffman Conjecture, but which is tempered, perhaps, by the effects of government small business subsidies. Finally, Part V applies the analysis to various issues attending the role of small business in economic growth, including the importance of small business in the economic growth of developing nations, by documenting the regulatory burden and summarizing what we can say confidently about the economic role of small business.

II. THE BASIC MECHANISMS OF ECONOMIC GROWTH

In order to clearly evaluate the various claims made about the importance of small business to economic growth, it is useful to consider carefully how economies grow. This Part presents a very simple statement of what economic growth means. Part II will then address how small business contributes to this process.

Economic growth means an increase in the economic value of resources available to the population. Put simply, there are three basic ways the resources of a nation or of the world can increase in value. First, existing resources can be reallocated within a country or as among countries to increase their value. Here, without changing the nature or extent of resources, a nation becomes richer and the world is enriched if resources are reallocated to those citizens or to those uses for which the value of the resources is the highest. As a general matter, the

availability of market exchange, though constrained by the costs of exchange, will facilitate this form of economic growth.¹³

The second mechanism of economic growth is closely related. The resources of a nation and of the world increase in value if they are employed relatively more productively: that is, if employing the same resources and labor, more value is generated in comparison to their use at some previous period. A central means for generating greater value from a given set of resources is the economic process of the division of labor. The division of labor—specialization of work tasks—can lead to the production of greater output from the same investment of labor and capital. Adam Smith in *Wealth of Nations* gives the example of the manufacture of pins in which a person working alone, undertaking each of the separate tasks of pin manufacture could complete (in Adam Smith's time) at most 10 pins per day; thus, 10 workers each working alone could complete 100 pins. Where the separate tasks of pin manufacture are divided among the workers—one drawing the wire, another tapping the heads, a third sharpening the points, and the like—Smith recorded the ten workers combined as completing 48,000 pins in a day.¹⁴ Though the pin example seems quaint today, the principle is universal, and specialization or the division of labor remains a significant mechanism of economic growth.

The third and final mechanism of economic growth is innovation, though the reallocation of resources to higher-valued uses and the division of labor might equally be regarded as forms of innovation. Separately, however, a nation and the world become richer where new resources are discovered, where new productive techniques are developed to enhance the value of resources,¹⁵ or where new products or services are invented using existing resources.¹⁶

These are the three central mechanisms of economic growth. The question to be addressed next is what is the role of small business in this process of economic growth?

III. THE ROLE OF SMALL BUSINESS IN AN ECONOMY

What are the determinants of the role of small business in an economy and how does small business, as compared to large, contribute to the process of economic growth? What determines the relative success of small, as compared to large, business? What are the forces leading to the distribution of firms of differential size in any economy?¹⁷

¹³ See ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS (R.H. Campbell et al. eds., Oxford University Press 1976) (1776) (providing a criticism of various governmental policies that constrain exchange, thus preventing economic growth of this nature).

¹⁴ *Id.* at 14-15.

¹⁵ This point closely resembles division of labor, except that a new productive technique may not involve labor specialization.

¹⁶ An example is Edison's invention of the light bulb.

¹⁷ There is substantial economic literature on the determinants of firm size. For recent discussions, see Michael D. Whinston, *Assessing the Property Rights and Transaction-Cost Theories of Firm Scope*, 91 AM. ECON. REV. 184 (2001); KRISHNA B. KUMAR ET AL., WHAT

We might begin this discussion by first addressing the question of how we should define a “small” business as compared to a business that is not small.¹⁸ There is no inherent definition of a “small” business. The definition is politically charged in the U.S. because of the many non-economic values that are alleged to derive from small business operations and because of the political importance of interests acting in the name of small business. Although the definitions often vary (and the power to define is often delegated for political reasons),¹⁹ U.S. agencies such as the Small Business Administration generally define a firm as “small” if it employs less than 500 workers.²⁰ This definition is basically arbitrary.²¹ If one takes the claims of the importance of small business to American values seriously, it is an interesting question what size of establishment is most likely to promote the values of independence, self-reliance and the like. It is not obvious that the answer to this question depends on the number of workers employed by a corporate firm in aggregate, as opposed to, say, the number of co-workers in the individual’s workplace or the extent to which the firm delegates decisionmaking. The various definitions of “small” business in American law are totally innocent of refinements of this nature.

The only available rationale for the 500 worker per firm definitional dividing line as between small and large business is that total employment in the U.S. is divided roughly in half as between workers employed in firms with greater and with less than 500 workers.²² Again, this distinction has nothing to do with values or productivity or any other plausible grounds for differentiating small from large businesses. Although there are many important practical implications of the definition of a “small” business—chiefly, for qualification for various governmental subsidies—for analytical purposes, a numerical definition is not important; thus, I will define the conception of a “small” business qualitatively, referring to nothing more than an establishment with some limited number of workers.²³ The empirical work *infra* examines the matter more discriminately.

DETERMINES FIRM SIZE? (Nat’l Bureau of Econ. Research, Working Paper No. 7208, 1999).

¹⁸ For a very helpful discussion of the treatment of this issue in modern U.S. public policy, see *Husbands, supra* note 4, at 364-70.

¹⁹ *See id.*

²⁰ *Id.* at 366.

²¹ *Id.* at 374.

²² Thus, in 1995 there were 52,652,510 workers employed in firms with less than 500 employees; 47,662,436, in firms with greater than 500. STATE OF SMALL BUSINESS 1997, *supra* note 2, at 76. As a general matter, political agencies such as the Small Business Administration want to increase the number of firms which qualify as “small” businesses. It, perhaps, strains credulity to describe firms with greater than 500 workers as small; thus, the less-than-500 worker demarcation maximizes the plausible set of what can be called small businesses. In other contexts, however, political pressures have led Congress to delegate the “small business” definition to its agencies. *See Husbands, supra* note 4.

²³ Brock & Evans define a small business as those businesses much smaller than the largest businesses in the same industry. BROCK & EVANS, *supra* note 7, at 4. This definition, though helpful in many contexts, is unworkable in industries dominated by what everyone would agree to be small businesses—say, dry cleaning—and of course remains dependent on

How does small business fit into an economy? First, many products and services command only small markets, *i.e.*, there exists limited consumer demand for the particularized product or service itself. Obviously, a limited demand can be satisfied by a firm of limited size—thus, a small business. Of course, limited demands can also be satisfied by large businesses where the business is able to coordinate production to meet that demand. Large businesses may not achieve such coordination in many contexts. Thus, an initial role of small business is to meet the demand of limited sets of consumers for particularized products or services where coordination costs prevent satisfaction of that demand by larger businesses.

Meeting limited demands is not a trivial role for small business in an economy. The larger the set of limited demands that are satisfied, the richer the economy will be. Put conversely, an indicia of an impoverished economy is one in which some variety of limited consumer demands are not satisfied in the market and consumers are left to satisfy their demands individually without the benefit of market exchange or division of labor, described above.

A large market, in contrast, is one in which there exists a sufficient concordance of consumer demand to take advantage of technological scale economies of production or distribution. A more precise definition, however, can be provided here. In many respects, no two consumers are alike and each consumer would prefer products and services most closely designed to meet his or her preferences. Over some range, however, the cost reductions from taking advantage of scale economies prevail over the magnitude of differences in consumer values and preferences for individually designed products.²⁴ Large business emerges where the cost savings from scale economies prevail.

In an interesting article, George Stigler attempted to relate the size structure of firms to the process of division of labor, elaborating on Adam Smith's famous aphorism that "the division of labor is limited by the extent of the market."²⁵ Adam Smith's point was that, as markets expand and become larger, there are greater opportunities to take advantage of specialization in production. This point, however, is not exactly related to the determinants of firm size. There is no doubt that Smith was correct²⁶ that specialization in production only becomes advantageous at a certain scale of production and, more perceptively, that as the scale of production increases, the benefits of specialization are likely to increase.

Production specialization and firm size, however, are not necessarily related. Specialization can occur within a firm or among firms. As Ronald Coase has shown, firm size is determined by the relationship between managerial efficiencies (costs) as among larger and smaller firms and the

the reader's understanding of "much smaller"; as an example, the former American Motors was always much smaller than General Motors and Ford.

²⁴ Brock & Evans define the converse as "economies of specialization." BROCK & EVANS, *supra* note 7, at 42.

²⁵ George J. Stigler, *The Division of Labor is Limited by the Extent of the Market*, 59 J. POL. ECON. 185 (1951), *reprinted in* THE ORGANIZATION OF INDUSTRY 129 (1968).

²⁶ My teacher, Ronald Coase, often commented that Adam Smith was always correct.

market transaction costs of arranging contracts among firms for the provision of productive inputs.²⁷ The existence of a firm indicates a substitution from managerial command—*i.e.*, a manager organizing production by direct employees—to transactions by contract through the market where production is achieved by someone else's employees. As Coase explained in 1937, if there were no market transaction costs, there would be no firms. Conversely, as market transaction costs diminish, there are greater opportunities for separate firms to individually manage different productive tasks.²⁸

One might, thus, amend Adam Smith's aphorism to read: the demand for the division of labor is limited by the extent of the market; the supply for the division of labor is limited by the relationship between managerial costs and market transaction costs. According to this view, businesses survive as small where their organization better succeeds in managing specialization in production and where these managerial efficiencies are not overwhelmed by the costs of market transactions.²⁹ Large firms, in contrast, survive where economies of scale in production or distribution are greater than the additional difficulties of large-scale management and the costs of market transactions.³⁰

In considering the contribution of small business to an economy, however, we should return to the general point that all consumers would prefer products that are more, rather than less, personalized. This creates inherent pressures toward making markets smaller and smaller, which is to say, more and more particularized to the demands of individual consumers. Large firms may well satisfy the demands of small markets but, by definition, the satisfaction of those demands increases managerial costs within the firm. Small business serves an economy by satisfying the demands of small markets for which there are no or lower scale economies of production or distribution. Small business also serves an economy by satisfying demands where the managerial costs of large business are greater than the market transaction costs of dealing by contract rather than by control within a firm. The lower the market transaction costs, the larger the scope of small business and the more that the specialized demands of small markets will be satisfied.

IV. MODERN REGULATION AND THE HUFFMAN CONJECTURE

In an important article published in 2000, Dean James L. Huffman set forth the proposition that increased levels of governmental regulation—health and safety regulation, employment regulation, environmental regulation, and economic regulation—inflict differential burdens on small and emerging

²⁷ R. H. Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386 (1937), *reprinted in* THE FIRM, THE MARKET AND THE LAW 33 (1988).

²⁸ *Id.*

²⁹ This point is similar to the analysis in Gary S. Becker & Kevin M. Murphy, *The Division of Labor, Coordination Costs, and Knowledge*, 107 *Q.J. ECON.* 1137 (1992), though they place greater emphasis on the growth of knowledge.

³⁰ Here, again, there are serious definitional problems since many large firms are internally organized as an affiliation of small firms. See BROCK & EVANS, *supra* note 7, at 27.

businesses in comparison to large businesses.³¹ These differential burdens derive from the combination of the fixed and variable costs necessitated by compliance with these various regulations. The differential burden on small business of an identical set of fixed costs is obvious. The variable costs of compliance are likely also to be higher for small business because compliance is likely to be attended by some level of scale economy.³² Although Dean Huffman did not elaborate the point, it is equally plausible that the expansion of enterprise liability since the 1970s in tort law has imposed differentially burdensome costs on small business.

Put in terms of the analysis in Part II of the determinants of firm size, the costs that derive from increased regulation and civil liability can be viewed as increasing the market transaction costs of dealing among firms as against within a single firm.³³ It follows that the costs associated with increased regulation and civil liability should affect the size structure of firms within the society as Dean Huffman predicted. As regulation and civil liability increase, there are increased cost incentives to shift production to a larger firm in contrast to production among some set of smaller firms. Empirically, therefore, holding other effects constant, we should observe a shift away from production in smaller firms toward production in larger firms as regulation and civil liability expand.

If true, there is a consequent welfare effect attending this change in production. The shift from production in smaller toward larger firms will mean that the opportunities in a society for meeting the demands of relatively smaller markets (or creating smaller markets) will decline, diminishing societal welfare. The diminution in welfare is likely to be difficult to measure because it represents, to take one example, a consumer shifting from a more personalized to a less personalized product—a shift that may not be recorded in measures of aggregate output. Moreover, to the extent that production through small business generates other, non-economic (or less economic) benefits, such as fostering a sense of independence or self-reliance, the shift from production in small toward large business will diminish welfare in those dimensions as well.

As described earlier, Congress has promoted small business over the years through a variety of statutory enactments providing preferences in government procurement, direct loan subsidies, subsidies of other forms, and tax benefits, among others. While these various benefits may serve to combat, to some extent, the effects on small business of the differential costs of regulation and civil liability, they often create other incentives as well. As is obviously necessary, each statute must define in some way those businesses that will

³¹ See Huffman, *supra* note 7, at 308. There is substantial literature attempting to test the effects of regulation on firm size. For a summary, see BROCK & EVANS, *supra* note 7. Brock & Evans also point out that some forms of regulation—as an example, local building codes—may differentially benefit small businesses as against large. *Id.* at 11.

³² See Huffman, *supra* note 7, at 313-315.

³³ Of course, it is important to distinguish costs of regulation that are essentially fixed by firm from those that vary according to firm output. It is the fixed costs of regulation that differentially burden small business.

qualify for the government largesse. Sometimes the qualifications for the small business preference will be defined in terms of total assets (not exceeding some number), total indebtedness, number of employees, magnitude of sales, or some other numerical indicia that separates those firms that qualify for the benefit from those that do not.³⁴ Because these benefits can be of substantial value, they too will have an influence on the characteristics of firm size.³⁵ That is, if a given procurement preference is available only to firms with, for example, less than one hundred employees, there are incentives to limit the job force within the firm to less than one hundred—incentives that may have nothing to do with the costs of organization through management versus transaction in the market. Also, because these incentives derive from governmental benefits, rather than costs, organizational changes in response to them represent a diversion of resources and, thus, will diminish rather than enhance societal welfare.

Empirical verification of the Huffman Conjecture, therefore, will be complicated by the consequences to firm organization of the provision of governmental benefits to small business. Here, however, the definition of “small” can be specified. There are no economic grounds for defining a business as small or not. In terms of economics, firm size will be determined by the relationship between managerial costs and the costs of market transactions. The government, in contrast, by defining the qualifications of those firms eligible to receive the government largesse, can directly establish incentives for the survival of firms of a definite size.

What has been the course of the size distribution of firms in the American economy over past decades? The next Part will attempt to look empirically at changes in the size structure of U.S. firms in recent years to examine the Huffman Conjecture.

V. U.S. PRODUCTION BY SMALL VERSUS LARGE BUSINESS, 1967-1995: TESTING THE HUFFMAN CONJECTURE

This Part attempts a preliminary empirical view of changes in production in the United States according to the size of the productive enterprise over the period 1967-1995. The study is preliminary, in large part, because of the difficulty of obtaining information about firm size despite the voluminous statistics published each year by the Small Business Administration. Each year, attached to the President’s *State of Small Business* annual report to Congress are hundreds of tables, presenting statistics on various aspects of small business operation. It seems immediately obvious that, if one were interested in the relative success of small versus large business, statistics on employment by firm size would serve as the most accurate measure. The Small Business Administration, which compiles these statistics, appears to have minimal interest in employment figures. The greatest attention in these statistics is given to the number of establishments—the number of different incorporations—

³⁴ See, e.g., Husbands, *supra* note 4, at 364-70.

³⁵ Brock & Evans have also described the effects of governmental incentives on reducing firm size. See BROCK & EVANS, *supra* note 7, at 101.

which is a peculiar statistic since it is generally unrelated to the aggregate number of citizens at work in these establishments. Determining from the statistics aggregate employment in firms of different size is possible, but difficult; the data are often incomplete and even contradictory within a given year's report. The data reported in Table 1 represent my best efforts in evaluating the available data over roughly a four-month research period.

According to the Huffman Conjecture, the increase in governmental regulation and civil liability over the past three decades should have had the effect of increasing the costs of market transactions, leading to a shift toward production in larger, as opposed to smaller, firms as market transaction costs increase relative to managerial costs. Conversely, to the extent that Congress has created incentives that benefit firms of different sizes, the economic effects of regulation and liability will be affected according to the particular firm size made eligible for government benefits.

Table 1 attempts to examine these implications empirically. It presents figures indicating the proportion of total U.S. employment from 1967 through 1995 according to size of firm measured in terms of number of employees. The empirical results presented below do not pretend to account in any comprehensive way for all of the determinants of firm size. These percentages are arrayed by year (where the data were available) to show the progression over time in the proportion of employees working in firms of differing size.

Table 1 presents very interesting results regarding the size distribution of firms in the U.S. economy over the past three decades. Column 1 shows that the proportion employed in the smallest firms—0 to 4 workers per firm—has declined consistently since 1978, consistent with the Huffman Conjecture. In 1978, 6.0 percent of the workforce was employed in the smallest firms; in 1995, that percentage had fallen to 5.37 percent. A somewhat similar trend affected workers in the next lowest size group—5 to 9 workers per firm. Although in the earliest year for which there is data—1978—a low of 5.7 percent of workers were employed in firms of this size, by 1982, that proportion stood at 7.62 percent. There have been progressive declines since, to 6.42 percent in 1995.

Perhaps a clearer picture can be obtained by focusing on changes in the largest firms—those with greater than 500 workers—indicated in column 7. If one simply observes the end-points, the changes appear to be modest.³⁶ In 1967, 46.84 percent of the workforce was employed in large firms; in 1995, 47.51 percent. Observed more carefully, however, there are a number of different waves of employment within the largest firm size category. Beginning in 1967 at 46.84 percent, the proportion of the workforce in the largest firms continued to increase until 1978 when it peaked at 53.7 percent. This was followed by a precipitous fall to 49.84 percent in 1980 and to 44.23 percent in 1982. Thereafter, the proportion of workers in the largest firms rose steadily again, reaching 50.3 percent in 1986. This was followed, again, by a

³⁶ Note, however, that in the context of roughly 40 million workers in firms of this size, a single percentage change is substantial.

precipitous fall in 1988 to 45.45 percent. The proportion of workers in the largest firms has steadily increased since then, to 47.51 percent in 1995.

What accounts for these developments? The subject needs further study, but it is entirely possible that these waves represent a combination of the effects predicted by the Huffman Conjecture—a general rise in employment by larger firms in response to the costs of regulation and liability—tempered at various moments by Congressional action creating incentives toward reorganization in smaller firms in order to take advantage of governmental subsidies. The precipitous drop-off in large firm employment in 1982, for example, appears principally to have been the result of a sudden growth in employment of firms with 20 to 99 employees. Similarly, the sharp drop-off in large firm employment after 1986 appears to be the consequence of, again, an equally sudden increase in employment of firms with 20 to 99 employees.

There is a potential explanation for these findings. As mentioned earlier, in 1980 Congress enacted four separate statutes attempting to reduce the regulatory burden on small business. The Paperwork Reduction Act of 1980³⁷ gave authority to the Office of Management and Budget to constrain paperwork demands on small business. The Regulatory Flexibility Act of 1980³⁸ compelled federal agencies to review proposed rules that would exert a “significant economic impact on a substantial number of small entities” and authorized those agencies to relax regulatory burdens on small businesses in response to such findings.³⁹ The Equal Access to Justice Act of 1980⁴⁰ empowered small businesses to recover legal costs in suits against the federal government. Finally, the Small Business Economic Policy Act of 1980⁴¹ required federal agencies and departments to coordinate activities to enhance the economic interests of small businesses.⁴²

None of these statutes created immediate effects. Each of them, instead, required federal departments and agencies to amend regulations in the future to benefit small businesses. Of course, it is not known definitively how extensively or how long this regulatory impulse to benefit small business continued. Though the findings here do not purport to serve as a study of the effects of these statutes, it is apparent from column 7 that the share of employment of large firms declined from 1978 (53.7 percent) to 1980 (49.84 percent)⁴³ and declined even further between 1980 and 1982 (44.23 percent). After 1982, however, the share of large firm employment again began to rise through 1986 (49.2 percent in 1984 to 50.3 percent in 1986).

³⁷ Paperwork Reduction Act of 1980, Pub. L. No. 96-511 § 2(a), 94 Stat. 2812 (1980) (codified as amended at 44 U.S.C. § 3501-3520 (2000)).

³⁸ Regulatory Flexibility Act, Pub. L. No. 96-354, 94 Stat. 1164 (1980) (codified at 5 U.S.C § 601 (1994)).

³⁹ BROCK & EVANS, *supra* note 7, at 23.

⁴⁰ Equal Access to Justice Act of 1980, Pub. L. No. 96-481 §§ 201-03, 94 Stat. 2321 (1980) (codified as amended at 5 U.S.C. § 504 (2000)).

⁴¹ Small Business Economic Policy Act of 1980, Pub. L. No. 96-302 §§ 301-03, 94 Stat. 833 (1980) (codified as amended at 15 U.S.C. §§ 631a-b (2000)).

⁴² These statutes are discussed in BROCK & EVANS, *supra* note 7, at 23.

⁴³ There are no available data indicating exactly when this decline occurred.

After 1986, there was further Congressional action. The National Defense Authorization Act for Fiscal Year 1987⁴⁴ introduced major reductions in the

TABLE 1: PERCENTAGE OF TOTAL EMPLOYMENT BY FIRM SIZE, U.S. 1967-95

Year	Firm Size by Number of Employees						
	Relatively Small Firms					Larger Firms	
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
	<u>0-4</u>	<u>5-9</u>	<u>10-19</u>	<u>20-99</u>	<u>All</u> <u><100</u>	<u>100-499</u>	<u>500+</u>
1967 ¹				18.23	39.93	13.22	46.84
1972 ¹				19.25	41.28	12.19	46.52
1976 ²				16.90	37.43	14.30	48.27
1977 ¹				18.54	40.12	12.36	47.50
1978 ³	6.0	5.7	6.3	15.2	33.2	13.1	53.7
1980 ²				16.36	35.37	14.78	49.84
1982 ⁴	6.49	7.62	8.93	19.53	42.57	13.19	44.23
1984 ⁴	5.7	6.4	6.9	17.0	36.0	14.7	49.2
1986 ⁵	5.4	6.2	6.7	16.8	35.1	14.7	50.3
1988 ⁵	5.69	6.90	8.26	19.16	40.28	14.52	45.45
1989	5.51	6.70	8.09	18.93	39.23	14.59	46.13
1990	5.47	6.68	8.07	18.94	39.16	14.50	46.32
1991	5.58	6.68	8.00	18.57	38.83	14.23	46.91
1992	5.57	6.68	7.96	18.44	38.65	14.33	46.99
1993	5.54	6.66	7.91	18.38	38.49	14.58	46.90
1994	5.49	6.54	7.79	18.29	38.11	14.59	47.26
1995	5.37	6.42	7.70	18.36	37.85	14.61	47.51

Note: Several Annual Reports provided only aggregate 0-19 worker percentages: 1967 = 21.7; 1972 = 22.03; 1976 = 20.53; 1977 = 21.58; 1980 = 19.01.

Sources: All derived from respective STATE OF SMALL BUSINESS: A REPORT OF THE PRESIDENT annual reports as indicated below.

- 1 1984 Report.
- 2 1988 Report.
- 3 1982 Report.
- 4 1987 Report.
- 5 1988 Report.
- 6 1988-1995: 1997 Report.

⁴⁴ National Defense Authorization Act for Fiscal Year 1987, Pub. L. No. 99-661, 100 Stat. 3816 (1986).

firm size standards for defense procurement.⁴⁵ The Small Business Administration predicted in 1987 that 509,403 firms within the economy would—if they remained the same size—lose their “small business” status on account of these size qualification reductions.⁴⁶ It is plausible, therefore, that the decrease in large firm employment between 1986 and 1988 represents not a refutation of the Huffman Conjecture but, instead, an effort to adjust to this legislation by changing firm size in order to take advantage of the new opportunities for small firms created by Congress, without regard to the economic fundamentals of firm organization.

If so, then the shifts in 1988 represent a form of step adjustment. The trends in firm employment in the years following the adjustment, through the most current figures available, again provide a test of the Huffman Conjecture. The data from 1988 through 1995 are entirely consistent with the Huffman prediction. Table 1 shows that the proportion of total U.S. workers employed in small business declined consistently over the period 1988 through 1995. Column 1, for example, shows that the percentage of all workers employed in the smallest businesses—less than five workers—declined from 5.69 percent in 1988 to 5.37 percent in 1995. There are similar trends among firms of 5 to 9 workers (a decline from 6.89 to 6.42 percent, column 2); firms with 10 to 19 workers (a decline from 8.54 to 7.70 percent, column 3); and in firms with 20 to 99 workers (a decline from 19.16 to 18.35 percent, column 4).

Conversely, columns 6 and 7 show that in firms of relatively larger size—100 to 499 workers (column 6)⁴⁷ and with greater than 500 workers (column 7)—proportionate employment has increased. Thus, the proportion of total workers in firms with 100 to 499 workers has increased, modestly, from 14.52 to 14.61 percent. The largest increase has occurred in firms with greater than 500 workers, in which the proportion of total employment has increased over the period from 45.45 to 47.51 percent (column 7).

A clearer measure of the relative changes in total employment as between relatively smaller and larger businesses is obtained by comparing columns 5 and 7. Column 5, a summation of columns 1 through 4, provides a total of the proportion of employment in all firms with less than 100 employees. Column 5 shows that the proportion of total employment declined from 40.28 percent in 1988 to 37.85 percent in 1995. Again, in contrast, column 7 shows that for

⁴⁵ For a description of these changes, see THE STATE OF SMALL BUSINESS: A REPORT OF THE PRESIDENT 1987 at 325-27; THE STATE OF SMALL BUSINESS: A REPORT OF THE PRESIDENT 1988 at 181-84. *See also*, Small Business Size Regulations, 13 C.F.R. §121 et seq. (2000) (proposed rules for implementing the size reductions).

⁴⁶ *See* Small Business Size Standards for Construction and Surveying Services Industries and Subcontracting Limitations, 52 Fed. Reg. 47937, 47940-41 (Dec. 17, 1987) (codified at 13 C.F.R. § 121).

⁴⁷ Note that this paper departs from the Small Business Administration definition of “small” here; the Small Business Administration continually trumpets increases in total employment within small business relying chiefly on aggregate totals, not relative percentage increases among all workers, and classifying firms with 100 to 499 workers—for which relative employment has increased over this period—as small businesses.

firms with greater than 500 employees, the proportion of total employment increased from 45.45 percent in 1988 to 47.51 percent in 1995.

These findings are suggestive of two propositions: First, the Huffman Conjecture—that increasing local, state and federal regulation imposes differential burdens on small business as compared to large—seems consistent with the data. Table 1 shows that over the periods 1967 through 1978, 1982 through 1986, and 1988 through 1995—periods over which it is plausible that the extent of regulation and civil liability were expanded—relatively large businesses grew more rapidly than small. Indeed, the differential growth in employment accelerated as between the early years represented in the data and the more recent years. The percentage differential as between employment in firms with greater than 500 workers and firms with less than 100 almost doubled from 1988 to 1995. These findings support the Huffman Conjecture.

The second proposition suggested by the data is that the magnitude of the effect of regulation and civil liability may be significant. As indicated above, the differential growth in large business employment is substantially greater than the increase in small business employment. This finding might be especially noteworthy since, as a rough evaluation, we might imagine that other determinants of the magnitude of market transaction costs—such as the growth of the internet and e-commerce—would seem to be reducing these costs, thus increasing the feasibility and attraction of small business production. At least through 1995, the aggregate forces appear the opposite; small business appears to be declining relative to large, not increasing as one would imagine from the vast facilitation of market transactions that has derived from the development of the internet.

These conclusions are preliminary; better and more recent data will indicate whether the relative decline in small business has continued through the past years in which internet development has accelerated even further. Nevertheless, the findings are interesting enough to warrant additional study of the effects.

VI. SOME FURTHER IMPLICATIONS

This Part expands, in a preliminary way, some of the implications of the analytical approach by suggesting further ways of thinking about the role of small business both in developed and developing economies.

A. Regulation, Civil Liability and Small Business

First, the hypothesis that expanded regulation and civil liability differentially harm small business and that these harms are reflected in the relative decline of small business in the years of study gains plausibility as the more precise mechanisms of the effect are taken into account. There exist both fixed and variable cost components to compliance with regulation and the standards of civil liability. It is straightforward that these costs are likely to be differentially burdensome to small business.

More precisely, however, the criticism of the effect of regulation on small business is that both the regulatory and civil liability processes must necessarily operate generally on all firms, large and small. As a consequence of these administrative constraints, the mandates of regulation and civil liability cannot be designed to address particular circumstances or the specific details of any business operation, but must be defined generally in a one-size-fits-all manner.⁴⁸ However effective in the aggregate this form of regulation might be (or however necessary regulation at this level of generality is because of bureaucratic constraints), it is ill-designed to deal with features particular to small and multi-varied businesses. As a consequence, small businesses are differentially disadvantaged by the expansion of these forms of regulation or civil liability.

The point, therefore, is not simply that greater regulation harms small business. Instead, the point is that the economic forces that generate demands which smaller businesses are relatively better able to accommodate are forces of specialization, responsiveness to specific and discrete demands, and particularization: all in conflict with forms of governmental regulation, whether through agencies or civil liability, that are necessarily less specialized, less responsive to specific conditions, and less particularized.

B. Small Business and Emerging Economies

One of the great economic puzzles of the modern era is why economies in many areas of the world—especially sub-Saharan Africa, India and China, other areas of Southeast Asia, and some areas of South America—have experienced such low levels (and in the case of many nations in sub-Saharan Africa, no level) of economic growth since the end of World War II. The most common recent explanation of the failure of growth in these countries is corruption, which is undoubtedly an important drain on an economy, though it is difficult to imagine a political elite able to rob a country of *all* of its increase in productivity.

The discussion of how market transaction costs influence the scope of small business suggests an additional insight into the problem. By definition, economies in emerging nations are small. Also by definition, small economies encompass small markets, if only because of the relative poverty of the country's citizens.

Following World War II, many developing countries adopted policies embracing the promotion of large business relative to small, often referred to as the policy of "import substitution." The basic concept of these policies was to inhibit imports so that a large manufacturing sector could develop internally within an insular nation. Import substitution policies—efforts to boot-strap an emerging economy into a developed economy—are today acknowledged by all to be abject failures for two principal reasons: First, they were notoriously unsuccessful; with very few exceptions no country adopting these policies has developed a significant manufacturing sector. Second, the policies deprived the

⁴⁸ For an elaboration of this point, see Huffman, *supra* note 7, at 316.

citizens of these countries of lower cost imports while the policies were in place.

A further phenomenon attending the failure of import substitution policies, however, is relevant to the subject here. Though it has not been adequately studied, it remains a surprise that at the same time that these countries' attempts to stimulate large business failed, there was also a failure to develop small business. These economies have remained stagnant without significant large or small business sectors. The absence of small business sectors is somewhat surprising given an acceptance of the possibility of the existence of small markets.

The relationship between small business and legal and market transaction costs may explain the absence of a significant small business sector. As Ronald Coase has taught, small businesses survive where legal and market transaction costs are relatively low. Where these transaction costs are high—perhaps because of insufficiently developed legal and contractual enforcement structures—organization in smaller corporate forms becomes increasingly costly. The failure of small business in emerging economies may be better attributed to the absence of stable legal and contractual regimes than to inherent failings in other economic dimensions.⁴⁹

VII. CONCLUSION: THE NORMATIVE JUSTIFICATIONS FOR PROMOTING SMALL BUSINESS

It is beyond the scope of this paper to outline in any comprehensive fashion the normative grounds for policies that promote small as against large business. Many of these grounds may be non-economic in nature, such as to encourage self-reliance, independence, free and unconstrained (or less constrained) endeavor, and the like. From the standpoint of economic analysis, it is not evident that there are clear normative grounds to prefer employment or productivity in a firm of larger or smaller size. The analyses of Coase and Stigler are normatively neutral with respect to firm size.

Though the point has not been developed sufficiently here, however, I believe that an argument can be made that satisfying more particularized consumer demands enhances consumer welfare and that small businesses are likely to be more effective in achieving this end. It would follow from this proposition that forms of regulation or civil liability that differentially affect small as against large business reduce societal welfare and that the shift in proportionate employment that we have observed over the past decade is evidence of that harm.

⁴⁹ For a vivid illustration of this proposition, see HERNANDO DE SOTO, *THE OTHER PATH* (June Abbott trans., Harper & Row 1989) (1817); *see also*, KUMAR ET AL., *supra* note 17, at 26 (showing in a cross-national study of Europe, that countries with better judicial systems have larger proportions of smaller firms within similar industries).

